OVERVIEW OF FEDERAL CREDIT

HEARINGS

BEFORE THE

TEMPORARY TASK FORCE ON FEDERAL CREDIT

OF THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

DECEMBER 10, 1981

FEBRUARY 10, 11, 1982

JUNE 22, 1982

◆

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
90-651 O WASHINGTON : 1982

S251-8

COMMITTEE ON THE BUDGET

PETE V. DOMENICI, New Mexico, *Chairman*

WILLIAM L. ARMSTRONG, Colorado
NANCY LANDON KASSEBAUM, Kansas
RUDY BOSCHWITZ, Minnesota
ORRIN G. HATCH, Utah
JOHN TOWER, Texas
MARK ANDREWS, North Dakota
STEVEN D. SYMMS, Idaho
CHARLES GRASSLEY, Iowa
ROBERT W. KASTEN, Wisconsin
DAN QUAYLE, Indiana
SLADE GORTON, Washington

ERNEST F. HOLLINGS, South Carolina
LAWTON CHILES, Florida
JOSEPH R. BIDEN, Jr., Delaware
J. BENNETT JOHNSTON, Louisiana
JIM SASSER, Tennessee
GARY HART, Colorado
HOWARD M. METZENBAUM, Ohio
DONALD W. RIEGLE, Jr., Michigan
DANIEL PATRICK MOYNIHAN, New York
J. JAMES EXON, Nebraska

Stephen Bell, *Staff Director*
Lizabeth Tankersley, *Minority Staff Director*
W. Thomas Foxwell, *Director of Publications*

Temporary Task Force on Federal Credit

SLADE GORTON, Washington, *Chairman*

WILLIAM L. ARMSTRONG, Colorado
RUDY BOSCHWITZ, Minnesota
ROBERT W. KASTEN, Wisconsin

JIM SASSER, Tennessee
HOWARD M. METZENBAUM, Ohio
DANIEL PATRICK MOYNIHAN, New York

CONTENTS

HEARING DAYS

Page

December 10, 1981 1
February 10, 1982 89
February 11, 1982 171
June 22, 1982 321

STATEMENTS BY COMMITTEE MEMBERS

Senator Andrews 36
Senator Boschwitz 321
Senator Domenici 20
Senator Gorton 1, 89, 171, 335
Senator Sasser 101
Senator Tower 172

WITNESSES

Barrett, Patricia, director of trade policy, National Foreign Trade Council 282
  Prepared statement 286
Fralick, James S., vice president, economic analysis department, Morgan Guaranty Trust Co. of New York 158
  Prepared statement 161
Greenspan, Alan, chairman and president, Townsend-Greenspan & Co., Inc 90
Hardin, Clifford M., director, Center for the Study of American Business, Washington University, St. Louis, Mo 109
  Prepared statement 114
Havens, Harry S., Assistant Comptroller General, U.S. General Accounting Office 78
  Prepared statement 80
Huard, Paul, vice president of the taxation and fiscal policy department, National Association of Manufacturers, accompanied by John D. Shillingburg, public issues manager, FMC Corp 182
  Prepared statement 186
Keeney, Cecil M., chairman, Committee for Title XI Vessel Financing 298
  Prepared statement 301
Kudlow, Lawrence A., Associate Director for Economics and Planning, Office of Management and Budget 3, 363
  Prepared statement 7, 364
Levin, Hon. Carl, a U.S. Senator from the State of Michigan 336
Mehle, Roger W., Assistant Secretary for Domestic Finance, U.S. Department of the Treasury 22
  Prepared statement 26
Mineta, Hon. Norman Y., a U.S. Congressman from the State of California 346
  Prepared statement 351
Motley, John J., deputy director of Federal legislation, National Federation of Independent Business 197
  Prepared statement 199
Percy, Hon. Charles H., a U.S. Senator from the State of Illinois 322
  Prepared statement 325
Proxmire, Hon. William, a U.S. Senator from the State of Wisconsin 339

	Page
Riedy, Mark J., executive vice president, Mortgage Bankers Association of America	212
Prepared statement	215
Rivlin, Alice M., Director, Congressional Budget Office	42
Prepared statement	45
Story, Robert, executive vice president, Seattle Mortgage	255
Prepared statement	257
Teeters, Nancy H., Member, Board of Governors, Federal Reserve System	60
Prepared statement	64
Utt, Ronald D., associate chief economist, Chamber of Commerce of the United States	173
Prepared statement	175
Waldo, Robert L., president, Mortgage Insurance Companies of America	260
Prepared statement	264
Warner, Miner H., vice president and manager, government finance groups, Solomon Bros., Inc	125
Prepared statement	129

ADDITIONAL MATERIAL

Q and A—Committee questions to witnesses, written:

Roger Mehle	382
Nancy H. Teeters	377

Statements:

Bethune, Hon. Ed, a U.S. Congressman from the State of Arkansas	574
Boeing Co	532
Graves, E. M., & Co., Investment Advisory, Inc	416
National Association of Independent Colleges & Universities	534
National Council of Farmer Cooperatives	423
National Rural Electric Cooperative Association	539
Shipbuilders Council of America	338
Small Business Coalition for Pollution Control	389

OVERVIEW OF FEDERAL CREDIT

THURSDAY, DECEMBER 10, 1981

U.S. SENATE,
TEMPORARY TASK FORCE ON FEDERAL CREDIT,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:28 a.m., in room 6202, Dirksen Senate Office Building, Hon. Slade Gorton presiding.

Present: Senators Gorton, Domenici, Andrews, and Quayle.

Staff present: Stephen Bell, staff director; David Nummy, special assistant to the staff director; Lizabeth Tankersley, minority staff director; and Ann Hadley, analyst for credit budget.

Senator GORTON. I would like to get started as promptly as I can, and because my opening statement will take until the time that we told Senators to be present, we can save a few moments.

OPENING STATEMENT OF SENATOR GORTON

I should like to welcome our witnesses to this initial meeting of the Task Force on Federal Credit. The Budget Committee is required by the Budget Act to study and to report to Congress methods to improve the congressional budget process. This task force has been asked to examine the activities conducted by the Federal Government which provide credit assistance, the relationship of those activities to the budget process, and, based on our findings, to recommend actions the full committee might take to meet our responsibilities under the Budget Act more effectively.

Senator Metzenbaum chaired the Special Subcommittee on Control of Federal Credit last year and his efforts have provided us a sound foundation for this work. I am pleased that he will serve as the ranking member of this task force. I am also pleased that other members serving on this task force will be contributing to our efforts in a very complex, but vital area.

The Budget Act was designed to allow the Congress to examine all financial activities of the Federal Government at one point in the legislative cycle, and to provide a rational process in which all information was available to allocate the resources of the taxpayers among competing national needs.

It is clear that in the area of Federal credit activities, work must be done to meet that goal of rational budgeting. The latest estimates available indicate that the Federal Government disbursed approximately $60 billion last fiscal year for direct loans. Yet, only about $9 billion, or 15 percent of that amount, will be reflected as net outlays in the budget.

The volume of loan guarantees last fiscal year is estimated to have been in excess of $60 billion, but these financial commitments are never reflected in the budget unless the borrower defaults. At that point, the resulting outlay is uncontrollable and the Congress has little discretion in the use of our resources.

Both direct loan and loan guarantee programs contribute significantly to the off-budget deficit, which has grown at an alarming rate of 41 percent per year since 1974—the year in which the Budget Act was enacted. The off-budget outlays for the current fiscal year is projected to be $22 billion; that is $22 billion beyond the traditional on-budget deficit. We cannot responsibly meet our duties as legislators and continue to ignore off-budget spending.

It is apparent that one cannot address the issues of Federal credit or off-budget spending without understanding the largest off-budget entity, the Federal Financing Bank, and the role it plays in Federal credit activities. In accordance with that need, we have asked the Congressional Budget Office to prepare a study of the Federal Financing Bank addressing the issues involved in its operations.

INVESTIGATE EFFECT OF FEDERAL PRESENCE IN CREDIT MARKETS

While the issues surrounding the relationship of credit and the budget process demand our attention, the effect of Federal credit programs on the Nation's financial markets is an issue equally worthy of our consideration. Federal participation in the U.S. credit markets this year is expected to be at about 43 percent of all funds raised. If you include debt receiving preferential tax treatment, the participation rate is some 50 percent.

I feel it imperative that we investigate the effect this Federal presence in the credit markets has on our interest rates, credit reallocation, and productivity. Moreover, we must understand what effect we have on the Nation's businesses and individuals who receive no Federal assistance when they seek to borrow funds.

If our actions in providing a direct or guaranteed loan denies funds to an equally or more creditworthy borrower who does not receive Federal assistance, then our assistance must be used sparingly and only when the policy objective justifies that effect.

The Budget Committee has addressed the issue of credit by incorporating credit targets in the budget resolutions. These targets, however, are nonbinding. When we understand more fully the issues of Federal credit activities, it will be appropriate to consider legislation dealing with credit—specifically, S. 265 introduced by Senator Percy.

I look forward to hearing the thoughts and insights which our witnesses here today will bring to us. I would ask, however, that their opening statements be summarized in no more than 10 minutes. Their prepared statements will, of course, be made part of the record. I should also ask that if any Senators have questions which are submitted for the record that the witnesses attempt to respond within 2 or 3 weeks.

With that, we will move to our first witness, and are delighted to have with us today Mr. Kudlow to start.

STATEMENT OF LAWRENCE A. KUDLOW, ASSISTANT DIRECTOR FOR ECONOMIC POLICY, OFFICE OF MANAGEMENT AND BUDGET

Mr. KUDLOW. Thank you, Senator. I will summarize my testimony briefly. We have discussed some of this before in private and I would be happy to have these remarks as brief reference points for the record.

LIMIT FEDERAL CREDIT PROGRAMS

First, I think nothing is more important for financial stability, the prospects for future economic growth and, indeed, economic recovery in 1982 than efforts to limit and curtail the veritable explosion of Federal credit programs in all their many forms in recent years.

We have observed not just excessive Federal spending habits, but also excessive borrowing, credit, and debt creation. All of this I think, has had a profound effect on the financial markets. We have seen a situation of imbalance for nearly 3 years. Yield curve relationships have been disrupted and the savings and investment process has been impaired. The recessionary conditions we find ourselves in today are in many respects, an unfortunate inheritance of these credit policies of the last 4 or 5 years.

INFLATIONARY AND ECONOMIC EXPECTATIONS

Second, my concern on credit is, to some extent, a psychological or attitudinal concern. That is, the public having witnessed these trends, is in a position to say that it expects the trends to continue.

The learning curve of the public, as you know, can be very steep, and people are increasingly well-informed about the financial situation. So, we have legacy of inflationary expectations with its effect on the buying and selling of financial assets. This in turn has a profound effect on the economy. Therefore, I am worried about the issue of inflationary and economic expectations and how the budget and credit issue has impacted those expectations.

SHORT-TERM DEMAND MANAGEMENT FINE TUNING

Also important is the issue of short-term demand management fine-tuning efforts. At present, I believe that most Americans reject the notion that government knows best, and in particular, they reject the notion that government knows best concerning the management of the economy.

Unfortunately many people fall back on credit adjustments as a substitute for direct budget outlay adjustments. I wish to point out that in most cases these credit adjustments are very close substitutes for the old "spend and spend" demand management fine-tuning philosophy.

Excess demand will not create rising supply. It will, however, create inflation and dramatic interest rate increases. The dismal performance of economic fine-tuning efforts in past years should be both a warning and a reference point for the credit budget process and any efforts to reduce outstanding credit programs.

MOVE UNCLE SAM OUT OF CREDIT MARKETS

It is very important to the financial perspective I alluded to a few moments ago (that is, the issue of signals) that the administration and Congress succeed in stemming the growth of credit, debt creation, and all forms of Federal borrowing. The direction of interest rates in 1982 and the out-years will depend in large part on the willingness of Washington to clearly signal the public, and more specifically the financial markets, that there are changes in policy and there will be changes in direction. One of the principal changes must be to move Uncle Sam out of the credit markets, in order to afford legitimate, productive, efficient private borrowers a chance to do their thing and to gain the necessary capital will enable private borrowers not only to form new plant and equipment, but also to restructure existing investments. In so doing, the growth in jobs over the next few years necessary to employ a healthy and expanding labor force will be created.

CREDIT EXPANSION MUST BE CURTAILED

As a reference point, again I wish to underscore my view (and the view of the administration) that the excess of Federal spending, borrowing, and credit has had an unmistakably adverse impact on our Nation's economy.

During the 1970's the explosive growth in debt and credit has inhibited all forms of investment and economic growth. Indeed, in my testimony I have tried to point out that the creation of real debt (that is, the Nation's debt adjusted for inflation) has exceeded the growth of real income and real GNP in recent years. If we take it a step further, real debt per capita exceeds the growth of real GNP per capita by a substantial amount.

The Nation is creating debt at an alarmingly rapid pace, but the Nation is not creating sufficient real income and output to sustain that debt, much less to sustain the kind of economic and investment expansion that the administration and the Congress desire.

Until we deal with this debt expansion, which is very much a part of your credit studies, we will find ourselves asking Americans to work and invest in the market each day, not to produce, not to create jobs, not to improve economic expansion, but instead to finance the profligate debt habits of the Federal Government. I think this is unwise.

As I said, the impact of these credit policies have made an unmistakable contribution to the slowdown in economic growth, the slowdown in productivity, and the increase in inflation and interest rates. This is not just a personal view; this is the President's view, and it serves as the key backdrop to administration policy regarding budget growth, deficits, credit programs, and debt creation.

As you know, to date the administration has taken a number of strong steps to put in policy the views that we have stated in words and in documents. In early November, the administration announced $20.3 billion reduction in the level of new Federal loan guarantees for fiscal 1982. This is the largest credit reduction ever proposed. I am happy to report to this task force that the 9 agencies and departments involved in the 15 programs in which we recommended cuts have reported to us that this loan guarantee action can be implemented through administrative channels. Such action will signal to the American public and the financial markets our seriousness.

The one exception, the Rural Electrical Insurance Fund, will go the legislative route. The administration will offer Congress our legislative proposals on that when the President presents the 1983 budget.

This is a major administration initiative which was first announced in September and detailed in early November. I am happy to report to you that we are on schedule. It represents the first step by the administration toward our goal of curtailing credit expansion. It demonstrates that we intend to back up our rhetoric with concrete actions. I believe we are on the road.

SUBSIDIES

Finally, let me raise a couple of points from my written testimony. Many credit programs have generated large subsidies by the Federal Government. This is a cost; it may be running as much as $11 billion a year by our estimates in a wide variety of programs. Subsidized credit not only creates inefficient Government-directed resource allocation but, in addition, it has a significant impact on the Federal budget and, consequently, imposes a significant burden on taxpayers.

We intend to pursue on the subsidy issue. We may have more to say about it in the upcoming budget in January. It is my hope that this task force will also address some of its efforts toward the subsidy issue.

FEDERAL FINANCING BANK

Another credit policy issue is the Federal Financing Bank, which you mentioned in your opening remarks. We agree that it is important to examine the FFB and particularly the FFB's programmatic underpinnings, which are the real issue. I will mention this only in passing because Mr. Mehle is directed to administer the FFB and will have much more to say on it. I mention it only because it is one of our policy concerns.

BRING CREDIT PROGRAMS INTO BUDGET PROCESS

Lastly, we are very much in support of efforts to move the credit policy programs out of the closet and out into the open. If this is accomplished, the executive and the congressional branches will be able to examine clearly these credit issues. Moreover, the public will be fully apprised of the extent, nature, and impact of all these credit programs.

Although the administration has not yet taken a position on a specific bill, we are in agreement with the thrust and direction of a number of the bills now moving through the legislative process which would bring the credit programs and the credit budget into the overall budget process.

These are important steps in the right direction. I hope and expect that, over time, the proper identification of all of these credit programs will lead to a policy judgment in the Congress in agreement with the administration's view that we must curtail this unlimited credit expansion. We must reverse the trends of the past few years. We must move government out of the markets. We must reduce inflationary expectations and interest rates in order to provide a strong foundation for economic growth in the 1980's.

Senator GORTON. Thank you, Mr. Kudlow.

PREPARED STATEMENT OF LAWRENCE A. KUDLOW, ASSISTANT DIRECTOR FOR ECONOMIC POLICY, OFFICE OF MANAGEMENT AND BUDGET

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss various aspects of the Federal credit program situation.

The unprecedented disruption of financial market activity which has occurred in recent years, along with the resultant malfunctioning of the savings-investment-economic growth process, is in no small part attributable to a nearly unlimited fiscal expansion characterized by profligate government spending, excessive Federal credit and debt expansion, and a steady cheapening in the value of money. And nowhere are these unsound financial practices better illustrated than in the unprecedented increase in the many forms of Federal and federally-assisted borrowing during the past four years.

The combined effects of this government credit activity -- direct Treasury borrowing, numerous categories of Federal loan guarantees, and a variety of government-sponsored enterprises and agencies -- have resulted in a steady increase in the rate of Federal absorption of capital raised in U.S. financial markets. During the late 1950's and the decade of the 1960's, the absorption rate of Federal credit hovered around the 15 - 20% range, with most interest rates at the time averaging 3 or 4%. During the 1970's this absorption rate jumped to nearly 25%, on average, as interest rates nearly doubled. By the late 1970's and early 1980's, however, the absorption rate took another quantum jump -- to nearly 40% -- while interest rates exploded into the double digit area.

	Average Federal and Federally-Assisted Borrowing			
	Volume ($b)	Absorption Rate (%)	3-mo. T-Bill (%)	20-yr. T-Bond (%)
1955-1969	9.8	16.6	3.5	4.2
1970-1979	58.1	24.9	6.3	7.5
1980	124.4	35.5	11.4	11.4
1981	154.5 (e)	43.0 (e)	14.3 (thru Nov)	13.7 (thru Nov)

The economic impact of this alarming rise in Federal deficits and other forms of government borrowing is unmistakable. Using a slightly different analytical framework -- one which emphasizes the impact of deficits and debt creation (excluding loan guarantees for the moment) -- the rise in real debt (adjusted for inflation) is clearly related to the slowdown in productivity and real economic growth and the acceleration of inflation which has occurred during the last major business cycle. From one business cycle peak to the next business cycle peak the growth of real debt per capita has accelerated from -1.8% during the lengthy expansion of the 1960's, to 0.8% during the intermediate length cycle of 1969-73, to 5.5% over the 1973-79 cycle.

But the growth in real per capita output has moved in the opposite direction, from 3.5% during the 1960's to 2.0% over the last cycle. Likewise, productivity growth has fallen from 3.1% to 0.8%, while the rate of increase in the GNP deflator has jumped from 2.6% to 7.5% over the period. Focusing on the 1973-79 interval, the Nation has produced real debt 175% faster than it has produced real income. Or put another way, the formation of real resources has been insufficient to cover the creation of real government debt, and thus has been inadequate to produce the real investment essential for the sort of steady economic growth and job creation necessary to employ a growing labor force.

Table 1

Growth of Privately Held Federal Debt 1/
(average annual growth rates measured between business cycle peaks)

	Nominal Debt	Real Debt 2/	Real Debt per Capita	Real GNP per Capita	Output per Hour 3/	GNP Deflator
1960-69	2.2	-0.5	-1.8	3.5	3.1	2.6
1969-73	7.0	1.5	0.8	2.7	2.6	5.1
1973-79	14.3	6.3	5.5	2.0	0.8	7.5

1/ Includes securities issued by both the Treasury and federally-sponsored agencies and excludes the debt held by the Federal government and the Federal Reserve.

2/ Real debt is measured in 1972 dollars.

3/ Private business sector.

A continuation of this rate of real debt creation during the years immediately ahead will generate even stronger inflationary expectations and unprecedented upward pressures on interest rates. If these pressures are permitted to develop, the prospects for sustained economic recovery will be severely diminished. Private borrowers will be increasingly forced to turn to short-term markets, yield curve relationships will become permanently distorted, and long-term investment prospects will suffer. Moreover, more efficient market-directed uses of funds will be preempted, while a growing number of less efficient borrowers leapfrog to the front of the credit line by virtue of the myriad forms of government credit assistance. And this new level of Federal intervention will disturb the link between market risk and real return to a degree never before experienced in our Nation's history.

Turning back to the concept of Federal and federally-assisted credit, direct loans outstanding have increased from $51.1 billion in 1970 to $164.0 billion in 1980. Primary guaranteed loans outstanding have increased from $126.5 billion in 1970 to $298.5 billion in 1980. Including the lending of Government-sponsored enterprises, total loans outstanding have tripled between 1970 and 1980, increasing from $201.5 billion to $613.5 billion. The average annual rate of growth in this total has also been increasing, from 7.6% during 1965-70 to 13.1% during 1975-80, and 14.5% in 1981, yet another indication of the explosion of credit under Federal auspices.

Table 2
GROWTH IN FEDERAL DIRECT AND GUARANTEED LENDING
(dollar amounts in billions)

	Actual			Preliminary
	1965-1970	1970-1975	1975-1980	1981
Direct loans:				
Outstanding, end of period	51.1	74.1	164.0	189.9
Average annual growth (%)	(5.3)	(7.7)	(16.3)	(15.7)
Primary guaranteed loans:				
Outstanding, end of period	126.5	198.3	298.5	327.6
Average annual growth (%)	(6.8)	(9.4)	(8.1)	(9.7)
Total:				
Outstanding, end of period	177.5	272.4	462.5	517.5
Average annual growth (%)	(6.4)	(8.9)	(10.6)	(11.9)
Total loans under Federal auspices 1/				
Outstanding, end of period	201.5	321.9	613.5	702.5
Average annual growth (%)	(7.6)	(9.8)	(13.1)	(14.5)

1/ Includes lending of government-sponsored enterprises.

To fully understand the loan guarantee process, it is important to recognize the pivotal role of the Federal Financing Bank. Under the aegis of the Treasury Department, the FFB purchases newly originated guaranteed loans with funds borrowed in money and credit markets. The proceeds of this borrowing are then converted into direct loans. Thus, with the aid of the Federal Financing Bank, a large portion of the government's loan guarantee commitments are converted into direct Federal loans which fall outside the budget.

The loans, however, are recorded as off-budget outlays through the FFB. Nevertheless, this procedure has generated the same additional Federal spending and borrowing that would be generated by an on-budget program. Thus, even though the FFB's borrowing requirement is not considered to be part of the official budget deficit, the resulting preemption of private capital is precisely the same as it is in the case of money borrowed to finance the official deficit.

This should not be construed as either criticizing the role of the FFB or suggesting that the FFB be placed on budget. The FFB serves a useful purpose in reducing the bond market congestion that would otherwise result if government agencies were to return to the practice of issuing their obligations separately. Further, channeling individual agency issues through the FFB results in interest savings for the government. Rather than placing the FFB on-budget, the budget process needs to be strengthened to ensure budgetary control over Federal credit programs.

But even the inclusion of off-budget outlays does not capture the full scope of the government's absorption of private saving. In 1980, for example, total Federal borrowing came to $70.5 billion. Guaranteed loans accounted for another $32.4 billion in government borrowing, while government-sponsored enterprise borrowing added another $24.1 billion. Thus, the true nature of total funds raised under Federal auspices summed to $124.4 billion, absorbing 36% of funds raised by the non-financial sector.

Table 3

BORROWING UNDER FEDERAL AUSPICES: ABSORPTION OF DOMESTIC CREDIT MARKET FUNDS
(fiscal years; in billions of dollars)

	1955-1959	1960-1964	1965-1969	1970-1974	1975-1979	Actual 1980
Total funds raised in domestic credit markets 1/	37.1	52.0	80.6	156.0	305.2	350.2
Federal borrowing	2.1	4.5	6.4	13.0	56.8	70.5
Guaranteed loans	4.7	4.4	5.2	14.4	14.1	32.4
Government sponsored enterprise borrowing	0.4	0.9	1.1	4.6	15.0	24.1
Funds raised under Federal Auspices	7.1	9.6	12.6	32.4	83.4	124.4
Federal Absorption rate	19%	18%	16%	21%	27%	36%
Average interest rates 2/	4.0%	4.7%	6.0%	8.2%	9.3%	12.8%

1/ Funds raised by non-financial sectors. Source: Federal Reserve Board Flow of Fund Accounts.
2/ Calendar year average of interest rates on corporate (Moody's) Aaa and Baa bonds.

The explosion of government and government-assisted credit has dwarfed the much discussed rise in deficits and has disrupted nearly all forms of economic and financial activity. Inflationary expectations have intensified, and have been accompanied by substantial upward interest rate pressures. The disruption of financial markets has also interfered with the conduct of monetary policy. Also important is the proliferation of Federal credit programs. Credit programs are an undesirable central planning mechanism which have forced an arbitrary shift of market risk and rearranged the queue of investment borrowers by providing government backing and below-market rates to those projects which the market would have financed only at a premium. As a result, the flow of private savings and capital is diverted away from the most efficient market-directed uses, and economic growth is undermined.

Additionally, unduly heavy Federal credit demands have forced a new permanent distortion of yield curves, in which short rate levels have exceeded long rates for the better part of the past three years. With the government absorbing an ever-growing share of private savings flows, particularly at the long-end of the maturity spectrum, private borrowers have been forced to rely almost entirely on short-term funds. This has caused highly inflated short-term borrowing costs and led to dangerously imbalanced corporate balance sheets. As a result, firms have been unable to rebuild outdated equipment and unable to create the most efficient production processes for the best labor performance.

Against this backdrop, it is important to recognize how much the public has been affected by the recent financial experience. Until people see concrete evidence of a permanent and reliable change in Federal budget, credit and debt policies, expectations of the near-term future will be dominated by events of the recent past -- high inflation, high interest rates, and an inhospitable investment climate. With the current prices of futures contracts on financial instruments foreshadowing sharp increases in both short- and long-term interest rates during 1982, the importance of controlling the growth in new Federal loan guarantees can not be minimized. These pessimistic expectations are not likely to be changed until budget discipline is restored and all Federal lending activity is brought under control. This suggests that we can not relax our vigilance to control the growth of Federal credit.

Interest Rates Implicit in the Settlement Prices
of Financial Futures Contracts for Selected Delivery Months
on 12/8/81

	Dec 1981	March 1982	June 1982	Sept 1982	Dec 1982
90-Day Treasury Bills (IMM)	10.5	10.7	11.0	11.3	11.6
90-Day CD's (IMM)	11.8	12.2	12.5	12.8	--

Consider now the Congressional budget process. As you know, the Administration is firmly committed to the long-term goal of gradually reducing the level of Federal credit programs through the development of tougher standards for their administration and the introduction of additional programmatic and interest subsidies controls. Efforts to formalize the Congressional credit budget process, or to integrate the credit budget directly with the regular budget, would greatly enhance this effort. Moreover, it is our hope that the Congress and the Administration can continue to work together to refine the "credit budget" concept and its use. Furthermore, the ongoing effort toward credit reduction and financial market relief should provoke a full examination of the proper accounting of these credit programs, with particular attention to the off-budget outlays.

The Administration enthusiastically supports the intent of proposed legislation which will amend the Congressional Budget Act and integrate Federal credit activity into the Congressional budget process. Those measures, S 265 proposed by Senators Percy, Helms and Hatfield, and HR 2372 proposed by Congressmen Mineta and Bethune, are important steps in the joint effort to restrict the adverse effects of Federal credit.

In addition, the future effectiveness of the credit budget will depend on how well it is integrated into the larger budget review process, particularly the reconciliation process.

Let me conclude with two additional issues. First, a key part of the Administration's overall credit policy concerns the role of government-sponsored enterprises. The President believes that the economy is best served by strong private financial intermediaries; and any exception seriously erodes the Administration's general policy of avoiding special relief measures for particular industries or economic sectors. With this in mind, it is anticipated that a number of the special competitive advantages now accorded to government-sponsored enterprises will be gradually phased out, encouraging each organization to compete equally with other private, unsubsidized financial intermediaries. We look forward to working together with Congress on this important matter.

Another credit policy concern of the Administration is the question of interest subsidies. The total present value cost of direct Federal interest subsidies that can be measured is estimated to be $11 billion in 1983. The present value of the interest subsidies is largest for the guaranteed student loan program and the Rural Housing Insurance Fund. The interest subsidies are deepest per $100 million of obligations in the foreign aid programs and Rural Housing Insurance Fund.

Future interest subsidies could be reduced by proposing reductions on a program by program basis as was done last February. Alternatively, interest subsidies in all Federal credit programs could be limited, as already proposed by some members of Congress. For example, one proposal would limit the program subsidy rate to no less than 3 percentage points below the interest rate for Treasury borrowing. This proposal would reduce the 1983 present value of Federal interest subsidies by 60%. If the program interest rate was limited to 2 percentage points below the Treasury borrowing rate, the present value of all subsidies would be reduced by 73%. These examples are but two of many possibilities to reduce unnecessary subsidies and lighten the burden of Federal credit and borrowing. On this issue, as well, we look forward to working together with the Members of Congress.

Senator GORTON. I think that we will hear from Mr. Mehle and then question the two of you jointly. But we are honored by the presence of the distinguished and courageous chairman of the Senate Budget Committee, Senator Domenici, and I would be delighted if he had a statement to make to us.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, I want to compliment you on the task force. I hope that the zeal that you have for this problem is not diminished by virtue of statements that were made yesterday by economic advisers to the President.

It would appear to me that if deficits do not make any difference, then your hearing is irrelevant. I do not know why we would be going to all this trouble if they do not matter and if they do not even have any direct or indirect effect on inflation. If that is true, then we ought not to be going to an awful lot of trouble to cut the budget. I hope the two witnesses do not agree with that. I may ask them that in a minute.

But even more incredulous is the assertion by these advisers that deficits do not have any effect on crowding out, and therefore have no effect on interest. That is a very interesting observation. I assume there is all the money in the world; that it does not matter how much the Government takes. That is exactly what you are trying to answer here.

If the notion is true that Federal Government involvement in money markets and deficits that are incurred by overspending have no relevancy, then obviously our concern about the back-door or off-budget approach to credit assistance through direct lending by the Federal Financing Bank and by virtue of the enormous interest subsidy provided by loan guarantee programs is wasting an awful lot of time.

But I do not think that is so, and I believe that we have got to get a hold of the Federal credit situation. I am hopeful that great legislative thrusts will come from this, and equally important, that a better understanding of the effect of off-budget Federal activities on the credit markets will be better understood.

I do not want to intervene further except to ask a quick question of Mr. Kudlow. Would it not be a fair statement that if Federal deficits do not have any relationship, directly or indirectly, to either inflation or interest that Federal credit would not either?

DEFICITS HAVE IMPACT ON RATES OF INTEREST AND INFLATION

Mr. KUDLOW. Well, if you agreed with the first assertion, which I do not, you would, of course, agree with the second. I would like to repeat briefly, if I may, a statement I made to Senator Gorton before you walked in.

The view of the administration is that the virtually uncontrolled growth of Federal spending, borrowing, credit programs, and debt has had an unmistakable and adverse impact not only on rates of interest and inflation. It has also absorbed valuable capital in the Nation's private financial markets. This in turn, has inhibited the very investment and economic expansion that the administration and the Congress desire in the 1980's.

Senator GORTON. Mr. Kudlow, you do not hold with Mr. Naskanin, then, that deficits do not matter?

Mr. KUDLOW. I would prefer not to comment on other views. I would only wish to underscore my own view and the view of the administration that deficits do indeed matter, off-budget deficits matter, and credit program deficits also matter. If we are unsuccessful in curbing the explosive growth in those areas, then it will be impossible for us to achieve the kind of reduced inflation and sustainable economic expansion that we all desire.

Senator GORTON. I am encouraged with that answer.

I think we will go on and let Mr. Mehle make his formal presentation, and then have a number of questions for both of you. Mr. Mehle?

Mr. MEHLE. Thank you, Mr. Chairman.

Senator DOMENICI. Mr. Chairman, before you do that, would you permit me one additional minute since I have to leave?

Senator GORTON. I certainly will.

CUT GROWTH OF FEDERAL GOVERNMENT

Senator DOMENICI. I understand that both of the witnesses are related to the administration; they work for the President. I will not be seeing him for a while, at least for a couple of days, so I want to take this occasion to say to both of you that this is one Senator that is not going to be engaged in the difficult job of curtailing and restraining the Federal Government, as difficult as that is going to be given the kinds of programs that we must cut, unless it is with a clear understanding that the President supports the notion that it is not an exercise in merely cutting the Federal Government. I am not interested in that; there may be some that are.

I am interested in cutting the growth of the Federal Government because it can have a salutary effect on the economy and the American people. I can assure you that it is going to be most difficult to get anyone to vote to cut anything unless it is for that principle.

There are too many Senators and Congressmen who feel that programs are good, and they may or may not be. It is going to be difficult to reduce the growth in programs unless it is for a higher and better general purpose, and that must be a healthy economy for more Americans.

I cannot make it any clearer; it is almost impossible to reduce spending when people in high positions say that deficits do not matter. I ask you what success we would have in cutting $2 billion from a continuing resolution that has already achieved substantial savings? What kind of success would we have when it requires cutting some very good programs that people support, if there is no real salutary effect and no economic value to the American people?

I regret to have to meander in over here and say this to you, but this is the first opportunity I have had to speak with representatives of the President in attendance who have some part in policymaking. I do not want you to think I will not communicate it directly; I will. I have not had a chance.

Mr. **Kudlow**. Senator, we will do our best to relay that message in, and I hope I can reassure you to some extent at least, that the administration's policy is very much in accord with your views.

Senator **Domenici**. Thank you very much. Thank you, Mr. Chairman.

Senator **Gorton**. Thank you.

Mr. Mehle?

STATEMENT OF ROGER W. MEHLE, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. **Mehle**. Mr. Chairman and Senator Domenici, I am glad to have the opportunity to discuss with you Federal credit programs and controls today.

FEDERAL CREDIT PROGRAMS AND CONTROLS

We believe that subjecting the extension of federally assisted credit to the annual rigors of the budget process is a positive and necessary step in demonstrating to the financial markets that the Government does intend to reduce the rate of increase in Federal spending, inflation, and interest rates. The work of this task force will be instrumental in that process.

This administration is committed to reducing the market impact of Federal credit programs by developing tougher principles and standards for their administration and applying new programmatic controls through both administrative and legislative actions.

In this regard, the President, in a November 5 memorandum to the heads of Federal agencies, as was mentioned a minute ago, suggested reductions of about $20 billion in new loan guarantee commitments in fiscal year 1982, and the agencies have responded favorably to this request.

The Federal credit program control system, proposed in the 1980 budget and implemented in the fiscal year 1981 budget, is intended to provide a systematic basis for review and control of new Federal credit activity on a program-by-program basis. Formalization of the credit budget in the congressional budget procedures will assist in our efforts to reduce Federal credit demands on financial markets. The administration has endorsed already the Mineta-Bethune bill, H.R. 2372, to formalize congressional controls over credit programs, and a companion bill, S. 265, has been introduced in the Senate by Senator Percy.

The administration's current control system works through appropriation act limitations on new obligations for direct loans and new commitments for guaranteed loans. These limitations are developed in the administration's budget review process, presented in the budget appendix, and acted on by Congress in regular appropriations bills. In addition, the budget committees include targets and ceilings for loans and loan guarantees in the congressional budget resolutions. However, these targets and ceilings are not now binding on the Congress in the same way as the restraints on budget outlays.

The controls are placed on the agency dealing with the public; interagency transactions are not controlled. Thus, the activities of the Federal Financing Bank are controlled indirectly to the extent that the activities of the agencies using the FFB are controlled. For example, the Farmers Home Administration makes direct loans to the public and finances its activities by selling certificates of beneficial ownership in its portfolio to the Federal Financing Bank. The direct loans to the public are covered by the control system. The sale of the CBO's by Farmers Home and the purchase of the CBO's by the FFB are not covered.

The system also does not yet apply to certain classes of complex transactions which have significant noncredit characteristics, such as lease-purchase contracts, callable capital, price guarantees, purchase guarantees, and project completion guarantees.

The activities of the Government-sponsored lending agencies, such as FNMA and the farm credit and Federal home loan bank systems, have been excluded from the credit control system because of their private ownership.

FEDERAL AND FEDERALLY ASSISTED BORROWING

While much public attention is focused on direct Federal borrowing to finance budget deficits, much less attention has been focused on federally assisted borrowing in the form of guaranteed loans. Yet, today, the amount of borrowing under Federal guarantee programs exceeds the amount of direct Federal borrowing to finance the budget deficit. We applaud this task force for helping to bring public scrutiny to this problem. Preliminary estimates for fiscal year 1981 indicate that of a total of Federal and federally assisted borrowing of about $142 billion, $58 billion, or 41 percent, was for the budget deficit, while the remaining 59 percent was net borrowing for off-budget programs. Taken together, it is clear that off-budget credit assistance from the Federal Government has become the largest component of total borrowing under Federal auspices.

While the myth seems to persist that guaranteed borrowings are substantially different from direct Federal borrowings and involve less Government intervention in the marketplace, this is simply not so. Every dollar of Government-guaranteed debt financed in the public marketplace is like Treasury borrowing to finance direct loans, and has a similar negative impact on private credit markets and interest rates.

Moreover, the increase in federally guaranteed credit activity in recent years has resulted in increased Government allocation of credit resources and undermined traditional borrower and lender relationships, as the Government assumed a greater share of the credit risk. Credit is diverted from productive private purposes; investment bankers become preoccupied with putting together "no-risk" deals underwritten by the Government rather than devoting their talents to their traditional, and critical, function of making markets for private borrowers and investors. Government competition for limited credit resources adds to financing costs borne by private borrowers who do not receive Federal credit aid, and this in turn leads to increased demands for credit aid to hitherto unassisted borrowers. Increasingly, political judgments rather than the free market discipline preempt the supply of credit. As the discipline of the marketplace is replaced by the political process in the allocation of credit, less economic activities are financed and productivity in the economy declines.

OFF-BUDGET FINANCING THROUGH THE FEDERAL FINANCING BANK

I will now turn to the issue of off-budget financing through the Federal Financing Bank. In the past, various legislative proposals have recommended that the FFB be placed on-budget as a means to control the Federal credit programs using the FFB. Yet, the FFB has a relatively passive role, lending to other Federal agencies and purchasing obligations guaranteed by them, and is not an appropriate or effective point of control. The FFB cannot provide funds for any purposes other than the programs for which Congress has already authorized the required financing. My full statement discusses the FFB in much greater detail.

In summary, efforts to control Federal credit programs should be focused on the individual programs themselves. Specifically, we need to deal with both the quantity and price of these programs. The quantity must be controlled through more effective budget-appropriations controls over all credit programs, including those financed through the FFB.

As to controls through the pricing mechanism, we believe that much can be accomplished through both legislative and administrative actions. Borrowers should be required to demonstrate that credit is not otherwise available on reasonable terms in order to be eligible for Federal credit assistance. Some credit programs have specific statutory provisions for low interest rates and other liberal loan terms and conditions. These should be tightened wherever possible. Higher interest rates, tightened eligibility standards, reduced maturities, increased collateral requirements, and other actions to make Federal credit aids less attractive would encourage would-be applicants to meet their credit needs in the private market without Federal aid.

Mr. Chairman, that concludes my statement and I will be glad to participate in the question and answer session.

Senator GORTON. Thank you, and that will begin in just a moment.

PREPARED STATEMENT OF ROGER W. MEHLE, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee:

I welcome this opportunity to discuss with you the Federal credit program control system. We believe subjecting the extension of federally-assisted credit to the annual rigors of the budget process is a positive and necessary step in demonstrating to the financial markets that the Government does intend to reduce the rate of increase in Federal spending, inflation, and interest rates. The work of this Task Force will be instrumental in that process.

This Administration is committed to reducing the market impact of Federal credit programs by developing tougher principles and standards for their administration and applying new programmatic controls through both administrative and legislative actions. In this regard, the President in a November 5, 1981 memorandum to the heads of Federal agencies requested reductions of $20.3 billion in new loan guarantee commitments in fiscal year 1982, and the agencies have responded favorably to this request.

R-520

The Federal credit program control system, proposed in the FY 1980 Budget and implemented in the FY 1981 Budget, is intended to provide a systematic basis for review and control of new Federal credit activity on a program by program basis. Formalization of the credit budget in the Congressional budget procedures will assist in our efforts to reduce Federal credit demands on financial markets. The Administration has already endorsed the Mineta-Bethune bill, H.R. 2372, to formalize Congressional controls over credit programs, and a companion bill, S. 265, has been introduced in the Senate by Senator Percy.

The Administration's current control system works through appropriation Act limitations on new obligations for direct loans and new commitments for guaranteed loans. These limitations are developed in the Administration's budget review process, presented in the Budget Appendix, and acted on by Congress in regular appropriations bills. In addition, the Budget Committees include targets and ceilings for loans and loan guarantees in the Congressional budget resolutions. However, these targets and ceilings are not now binding on the Congress in the same way as the restraints on budget outlays.

The controls are placed on the agency dealing with the public; interagency transactions are not controlled. Thus, the activities of the Federal Financing Bank are controlled indirectly to the extent that the activities of the agencies using the FFB are controlled. For example, the Farmers Home Administration makes direct loans to the public and finances its activity by selling certificates of beneficial ownership (CBO's) in its portfolio to the FFB. The direct loans to the public are covered by the control system. The sale of the CBO's by FmHA and the purchase of the CBO's by the FFB are not covered.

The system also does not yet apply to certain classes of complex transactions which have significant non-credit characteristics, such as lease-purchase contracts, callable capital, price guarantees, purchase guarantees, and project completion guarantees.

The activities of the Government sponsored lending agencies, such as the Federal National Mortgage Association (FNMA), the Farm Credit and Federal Home Loan Bank Systems, have been excluded from the credit control system because of their private ownership.

While much public attention is focused on direct Federal borrowing to finance budget deficits, much less attention has been focused on federally-assisted borrowing in the form of guaranteed loans. Yet today the amount of borrowing under Federal guarantee programs exceeds the amount of direct Federal borrowing to finance the budget deficit. I applaud this Task Force for helping to bring public scrutiny to this problem. Preliminary estimates for FY 1981 indicate that of a total of Federal and federally-assisted borrowing of $142.4 billion, $58 billion or 41 percent was for the budget deficit, and the remaining 59 percent was net borrowing for off-budget programs. Taken together, it is clear that off-budget credit assistance from the Federal Government has become the largest component of total borrowing under Federal auspices.

While the myth seems to persist that guaranteed borrowings are substantially different from direct Federal borrowings and involve less Government intervention in the marketplace, this is not so. Every dollar of Government guaranteed debt financed in the public marketplace is like Treasury borrowing to finance direct loans and has a similar negative impact on private credit markets and interest rates.

Moreover, the increase in federally-guaranteed credit activity in recent years has resulted in increased Government allocation of credit resources and undermined traditional borrower/lender relationships as the Government assumed a greater share of the credit risk. Credit is diverted from productive private purposes; investment bankers become preoccupied with putting together "no-risk" deals underwritten by the Government rather than devoting their talents to their traditional, and critical, function of making markets for private borrowers and investors. Government competition for limited credit resources adds to financing costs borne by private borrowers who do not receive Federal credit aid, and this in turn leads to increased demands for credit aid to hitherto unassisted borrowers. Increasingly, political judgments rather than free market judgments, preempt the supply of credit. As the discipline of the marketplace is replaced by the undisciplined political process in the allocation of credit, less economic activities are financed and productivity in the economy declines.

I will now turn to the issue of off-budget financing through the Federal Financing Bank. In the past, various legislative proposals have recommended that the FFB be placed on-budget as a means to control the Federal credit programs using the FFB. Yet, the FFB has a relatively passive role, lending to other Federal agencies and purchasing obligations guaranteed by them, and is not an appropriate or effective point of control. The FFB cannot provide funds for any purposes other than programs for which Congress has already authorized the required financing.

The FFB was established in 1973, at the request of the Treasury, to deal with severe debt management problems resulting from years of off-budget financing which had flooded the Government securities market with a variety of Government-backed securities. These securities were financed outside the Treasury by various Federal agencies seeking to avoid the discipline of the budget-appropriations process. Although the securities were backed by the Government they sold at relatively high interest rates and fees, they competed with Treasury securities, undermined Treasury debt management policies, created serious marketing problems, and placed Treasury in a position of being required to approve agency market issues on terms which Treasury felt were simply too expensive for the financing of Government programs. The only beneficiaries of the proliferation of Government-backed securities, apart from the agencies that escaped budget-appropriations controls, were the investors and investment bankers who profited from the higher interest rates and fees.

The FFB was a response to a need for control and rationalization of the financing of Federal programs, primarily credit assistance programs. This need arose from three basic trends: (1) the rapid growth of Federal credit assistance programs, (2) the shift from direct loans (on-budget) to guaranteed loans (off-budget), and (3) the shift from guaranteed loans financed by local lending institutions to guaranteed obligations financed directly in the securities markets. These trends have continued and have contributed to the explosive growth of Federal guarantee programs which has occurred in recent years.

Nevertheless, the FFB has served to facilitate the control of Federal credit programs. By consolidating the borrowing of various agencies, the FFB has made the problem of unrestrained growth in Federal credit more visible and has underscored the need for more effective control. The FFB has also helped to restrain some of this growth, since it has reduced incentives for private investment bankers to promote and develop programs for financing Government-guaranteed securities directly in the market. In fact, without the FFB, we would have been faced in fiscal year 1981 with an additional $21 billion of direct securities market financing by Federal agencies using various forms of guaranteed market issues, asset sales, loan poolings, lease financing, and other devices which the agencies used prior to the establishment of the FFB. Such financing techniques are far more costly to the Government and to the guaranteed borrowers and create serious debt management problems for the Treasury, since they involve the issuance of fully guaranteed securities in direct competition with Treasury's own issues.

Unfortunately, the FFB seems to have become a scapegoat for the Federal credit program control problems which have arisen. It is a common misconception that the FFB, because of its off-budget status, is in itself a means to avoid budget control. The FFB was created strictly for the purpose of reducing the costs of Federal and federally-assisted borrowing from the public in a manner least disruptive to private financial markets and institutions. The FFB is simply a debt management tool of the Treasury. The FFB itself does not affect either the budget status or the authorized program level of the agencies using the FFB. Within the Administration, the actual allocation of budget and credit resources to various agencies and programs is determined through the OMB budget process. Efforts to control off-budget Federal credit programs should be focused on the programs themselves, rather than on the FFB.

There has also been concern that the interest cost savings afforded to agencies using FFB financing provides an additional and unwarranted incentive to borrow and may further increase demands for expanded and new guarantee programs. Yet the bulk of the interest rate savings made possible by FFB financing is now captured by the Federal Government in two ways. First, the FFB charges its borrowers an interest rate one-eighth of one percent higher than the Treasury's, and thus the FFB's, cost of borrowing. Since the administrative expenses of the

FFB are relatively insignificant the FFB accumulates surpluses, which are regularly turned over to the Treasury. The FFB's current surplus is approximately $30 million; since its establishment in 1974 the FFB has turned over $606 million to the Treasury.

Additionally, the FFB purchases from Federal agencies direct debt issues as well as loans that these agencies have made to private borrowers. These activities constitute the bulk of the FFB's lending operations. If the agencies were required instead to sell their debt issues or loan assets directly in the private market, they would realize lower sales prices which would add to budget outlays by the agencies and to the total outlays in the President's budget. (In most cases, the agencies lend out the money they receive from the FFB at below market rates, making up the subsidy through appropriated funds).

The second group of beneficiaries from consolidated financing through the FFB are the programs involving Federal agency guarantees of borrowings by non-Federal entities from the FFB. Yet, even here much of the savings is realized by the Government, rather than by the guaranteed borrowers. An extreme case is the guaranteed public housing program, where all of the savings goes to the Government, rather than to the guaranteed borrowers, since all interest costs for public housing projects are borne by the Government. If, in cases where guaranteed loans financed by the FFB actually reduce costs to private borrowers somewhat below the costs of guaranteed financing in the market, it is determined that this added interest rate savings should not be passed on to guaranteed borrowers, then this could be accomplished through increased guarantee fees or other offsetting devices, rather than by removing the program from the FFB.

An alternative approach would be to have the FFB raise the interest rate it charges its borrowers. Yet, as indicated above, in many programs this would require an increase in budget outlays by Federal agencies issuing, selling, or guaranteeing obligations purchased by the FFB, while the interest rate charged the private borrowers whose loans are financed through the FFB would not necessarily increase. In such cases, the net effect would be an increase in total budget outlays and, when the additional FFB profits are turned over to the Treasury, a corresponding increase in total budget receipts. Clearly, the better approach would be to require each agency using the FFB to charge higher interest rates or fees to the private sector borrowers financed through the FFB. In this way, we could actually reduce the budget deficit, and even more of the savings from FFB consolidated financing would be realized by the Government.

As I stated earlier, efforts to control Federal credit programs should be focused on the individual programs themselves, rather than on the FFB. Specifically, we need to deal with both the quantity and price of these programs. The quantity must be controlled through more effective budget-appropriations controls over all credit programs, including those financed through the FFB.

As to controls through the pricing mechanism, we believe that much can be accomplished through both legislative and administrative actions. Borrowers should be required to demonstrate that credit is not otherwise available on reasonable terms in order to be eligible for Federal credit assistance. Some credit programs have specific statutory provisions for low interest rates and other liberal loan terms and conditions. These should be tightened whenever feasible. Higher interest rates, tightened eligibility standards, reduced maturities, increased collateral requirements, and other actions to make Federal credit aids less attractive would encourage would-be applicants to meet their credit needs in the private market without Federal aid.

Thank you.

ADMINISTRATION'S SUPPORT NEEDED IN CURTAILING FEDERAL SPENDING

Senator GORTON. I do wish to take this opportunity to echo something which the chairman of the full committee stated.

In taking back such messages as you receive when you come to the Senate, I think it is vitally important for you to inform the administration of the great additional difficulties which were placed in the path of those who have sought to help create a fiscally more responsible attitude toward not only these credit markets, but, of course, toward the overall budget by the kind of remarks which we read in the newspaper yesterday from a member of the Council of Economic Advisers.

If the only justification for cutting the budget or for reducing the intrusion of the Federal Government into credit markets is that, somehow or another, the programs which are being financed directly or indirectly by the Federal Government are totally unworthy and counterproductive taken as individual programs because they have no impact on the economy whatsoever, there is no possibility that the administration will be successful in curtailing Federal spending or Federal credit.

Members of this committee, both Republicans and Democrats, and the Members of the Senate, both Republicans and Democrats, took very difficult political positions during the course of the spring, summer, and fall, and are still being asked to do, in curtailing Federal expenditures in order to reduce the rate of inflation, in order to reduce interest rates, and in order to create a more productive economy for all of the citizens of the United States. If the administration directly or indirectly is going to communicate the thought to us that these acts have had, and will have in the future, no measurable impact on the economy, inflation, or interest, there is going to be no interest on the part of the Congress in following that course of action.

I do not believe that to be the case. I am convinced that the two of you do not believe that to be the case, but the more frequently you can reiterate that and the more that you can carry that to even higher positions in the administration, the better off all of us who seek fiscal responsibility are going to be.

Again, before questions, we also have present Senator Andrews. We have not started the questioning yet, Mark, but if you have an opening statement, we would be delighted to hear it.

OPENING STATEMENT OF SENATOR ANDREWS

Senator ANDREWS. Well, yes. Actually, I do not know whether you call it an opening statement or a lecture or an expression of concern. I am getting to be a little bewildered by the conflicting signals we are getting from the administration. Yesterday's indication that deficits do not matter is just part of the overall picture that has been causing us concern for a long time.

CONFLICTING SIGNALS COMING FROM THE ADMINISTRATION

The people in this country voted for Reagan for President and voted to change the makeup of both Houses of Congress quite considerably because they wanted changes made in the way our monetary system was functioning. They wanted to get at high interest rates; they wanted to get excessive government spending under control.

As a result the President came up with a number of suggestions and the Congress followed. This committee gave him more than the cuts he asked for in spending. It was difficult to whittle programs that are worthwhile. It is difficult to cut, for instance, the Coast Guard search and rescue stations and all the rest. Now we are being told that deficits do not really matter.

Further, it is difficult to explain why we should go along with tax cuts when, in the case of one railroad in my part of the country, the Burlington Northern, now as a result of what the President let go by in the tax package when nobody was looking, is going to get $200 million as a windfall this year by depreciating rights-of-way. God, I have been a farmer all my life and nobody ever told me I could depreciate the south 80, and I still cannot.

Senator DOMENICI. Why did you not put it in the bill? [Laughter.]

Senator ANDREWS. I guess I was asleep, but I had nothing to do with that crazy tax bill. It came through and the President was asking for his $550 billion; particularly when it got over to the House, they must have thought it was a Christmas tree coming along and they added more ornaments to it than anybody could imagine.

I think they ought to come out and confess to having made a mistake. Instead of asking for tax hikes, they ought to say they made a mistake in going along with the large tax cut which included loopholes such as the leasing provisions. They ought to get it whittled back to the original tax plan.

ADMINISTRATION GOING IN TWO DIFFERENT DIRECTIONS

The thing that we are talking about immediately, though, that concerns me is that I am on the subcommittee that funds the Defense Department, and it seems the administration is going in two different directions. I had some top people from the Defense Department—some of our military people who had stars on their shoulders—come in the other day and they told me how desperately we need a new, modern cargo plane to help our rapid deployment forces. It is a multibillion dollar program. Why do we need it? We need it to safeguard our access to oil supplies in the Middle East; we need it to protect our economy and economy's ability to get adequate oil supplies.

At the same time, this administrations saying that energy is not that important. The Office of Management and Budget has told us that the rural electrics should not be able to borrow from the FFB. In reality such borrowing does not cost the Government anything.

If you take away the incentive to produce energy here at home, you are going to spend more and more billions and risk hostility because we continue to be totally dependent on somebody else for our energy supply. The only way we are going to become energy-independent is to stimulate the production of energy here.

I have just gotten to the point where the signals that you are sending up from the Office of Management and Budget are so at odds with signals that are coming from other parts of the administration that they do not make any logical pattern anymore.

The difficulty we have in getting the American public to go along with the programs of austerity will be to explain now why one branch of the Government is sending one kind of signal and another branch is sending another kind of signal. I do not know how we can keep going.

As to budget deficits, the administration comes up with the idiotic posture that we do not have to do anything now; we can wait until January. That was the posture they took last month. You try to tell that to a small businessman or a farmer, or whoever else, that it does not matter right now; we can wait until next January, and do not worry about getting the budget under control.

This committee asked the Office of Management and Budget and the President to give us some concrete backing for our second budget resolution. In effect, we are told, "Punt. We will get around to looking at it 2 or 3 months down the line."

You know, this is not something that the livestock feeders, the hardware store owners, the automobile dealers, the homebuilders, or whoever else, out in the sensible part of this country—the non-Washington, D.C., part of this country—can afford to stand for another 60 days or another 90 days of inattention on.

CROSS CURRENT OF SIGNALS CONFUSING

Those of us who sit on this committee are supposed to know, and I guess you are not supposed to admit that you are confused, but I have yet to talk to one of my colleagues from either the Democratic or Republican side who say that they are not confused and bewildered at this seemingly cross current of signals that is coming from the administration.

I came over here to glance through these statements to see if you could shed any light on any consistency of patterning and, again, I fail to see it. Maybe I am not perceptive enough. I am going to listen to the line of questioning that my distinguished colleague and good friend, Mr. Gorton, brings out, and perhaps he will shed a little light on my problem.

Senator **Gorton**. I think it only fair to let each of the witnesses comment briefly, if he wishes to do so, on your statement Senator.

Mr. **Mehle**. Well, I see a line of questioning that is a little different from that which I came to respond to. [Laughter.]

And it seems to be focused around the budget resolution.

Senator **Andrews**. It is focused on the inconsistency of the program.

Mr. **Mehle**. You have been looking at me the whole time you have been saying that, and saying "OMB." [Laughter.]

I am from the Treasury Department. [Laughter.]

Senator **Andrews**. I know, but OMB is not far away. [Laughter.]

And whether it is Regan or Reagan, they are all in the same box, so to speak.

Mr. **Mehle**. Well, in seriousness, I think perhaps a response to your questions about the budget resolution might be furnished. I am not particularly well-positioned to do it; I think probably you are.

Mr. **Kudlow**. Thank you, Mr. Mehle. [Laughter.]

Senator, you covered a lot of ground in your statement and I am not sure I can answer all of the questions. I will only comment briefly on a couple of points I noted.

ADMINISTRATION WORKED WITH LEADERSHIP TO DEAL WITH BUDGET PROBLEMS

First, with respect to the budget procedures this fall, I think the administration has worked very closely with the leadership in both the Senate and the House to find the best way to deal with these budget problems.

Senator **Andrews**. I know they worked very closely with us. I was one of the conferees on the continuing resolution, and all through that Friday and Saturday, we had one set of figures; we signed off on it—Mr. Baker and Michael. And Max Friedersdorf was standing over there said, "Hooray, we have done it." And then sometime during the night, your fearless leader came up with a new mirror—he says he does it with mirrors—and everything that was said before went out the window.

Mr. **Kudlow**. I can only say that those of us who work closely with the quantitative aspects of the budget process recognize the delicacy with which these numbers are constructed and how easily very technical nonpolicy, nontechnical influences—such as definitions—can affect them.

Although we may not satisfy everybody all the time, we place a premium on honesty in trying to show the Members of Congress, at least from our viewpoint, though others may disagree, what we believe are the most accurate, up-to-date numbers.

With respect to the budget process itself, although there was certainly confusion and uncertainty from a variety of sources, it seems to me that the administration and the congressional leadership are now well on their way to agreement. That is the most important issue.

ACHIEVE STRONG, CONSISTENT AND RELIABLE BUDGET RESTRAINT

Next to that, the next step is to develop a budget for 1983 which embodies the kind of restraint that Senator Domenici and many others have urged, and that we support. We intend to work as hard as we can, 7 days a week, 16 hours a day, to achieve those goals.

I want to repeat to you what I mentioned in response to questions from Senator Gorton and Senator Domenici. The policy of the administration always has been to achieve strong, consistent and reliable budget restraint to change the pattern of fiscal excesses which has been so dominant in recent years. We are not attempting an academic exercise. This restraint will generate the salutory effect of lower inflation and interest rates and greater economic recovery in the years ahead.

We do it with sincerity; I hope we do it as effectively as possible. It is a darned hard task, but it seems to me we have made a lot of progress in calendar 1981, and we look forward to making additional progress in calendar 1982.

Senator GORTON. Mr. Kudlow, thank you. It is in one sense unfair to the two of you to ask you a series of questions that are outside of your testimony and this task force. I do have one or two questions on point for each of you, and because we have kept you an extra time and because we have several other witnesses today, I am going to limit my questions to one or two each.

ACCURATE AND RELIABLE DATA BASE BEING DEVELOPED

Mr. Kudlow, if we begin to treat credit in a manner similar to direct spending, we have got to have the information which is comparable given to Congress as frequently as we do on direct spending. Does the administration have plans to provide multiyear budget information for credit and updates on credit budget information each time direct spending information is updated?

Mr. KUDLOW. Yes. With respect to the updates we are doing the best we can to develop an accurate and reliable data base. This is a very tough, almost dicey issue because, as you know, the quantitative aspects of the Federal credit have not been fully explored until recently—only in the last few years.

We are moving ahead to feed into the computers the most up-to-date information, and to do so as frequently as possible.

As for multiyear budgeting for credit, it is an issue which deserves further consideration and exploration. As yet, I think a final judgment on it is unresolved. But we certainly intend to improve all the aspects of the credit data base.

Senator GORTON. Mr. Mehle, in order to monitor budget execution for the credit budget, it is necessary to have access to timely reporting of actual direct loan obligations and loan guarantee commitments by executive agencies. Does Treasury have any plans to implement the collection and reporting of information of that sort on a monthly basis?

Mr. **Mehle**. No, Mr. Chairman. Those kinds of data are developed by the program agencies themselves and probably are not available on a monthly basis. I think for the most part, they are kept quarterly by the program agencies. But you are quite right; you do need those kinds of things in order to tighten your control.

Senator **Gorton**. Will you even collect them and disseminate them on a quarterly basis in Treasury?

Mr. **Mehle**. The Treasury Department would not have any plans to do that. I think it is best done in the program agencies themselves where these data are already being collected and compiled.

Senator **Gorton**. I will ask one other question of a little more philosophic nature, and then submit the balance in writing.[1]

EXPLORE BREAKDOWN OF NEED FOR FEDERAL CREDIT ASSISTANCE

Presumably, Federal credit assistance of whatever kind is justified on the grounds of the failure of the market in certain sectors of the credit market itself. Can either of you—I think particularly you, Mr. Kudlow—tell me what sectors have a particular need for Federal credit assistance which would not be able to obtain that assistance in a free market?

Mr. **Kudlow**. Well, that is a very difficult question—a very difficult question. I respond that way because, as you know, my view is that too frequently in the past policymakers have reached a judgment on the so-called failure of the market to permit normal credit flows or adequate credit flows to certain sectors. That judgment has been reached, I think, too hastily in many cases.

Now, I do not deny the possibility that there are some legitimate cases where normal credit flows are not available. But having made that general statement, I am not sure what I would pinpoint at this moment. I feel that it is a terribly important question—in many ways, one of the most crucial questions, because virtually every sector of the American economy today is badly in need of new capital infusion, and we want them to have it. But we also want them to have it on pricing terms—that is, interest rate terms—which are reasonable and which are fair and equitable.

We want the capital to flow in a way that allows all the potential borrowers and users of this capital to have equal access on equal terms. So, the issue of where the breakdown is is something we should explore. I hope that when we make this exploration in the months ahead, working with this task force and other bodies, we will do so in a rigorously analytical fashion and we will recognize that it is a very broad question which goes to the very heart of the capital market, the financing, savings, investment, and economic process.

Senator **Gorton**. What you are saying is that at this point, at least, we not only do not have the answers, but we do not even have the framework in which those answers can be reached objectively.

Mr. **Kudlow**. I confess that much of what you say is true. Further, I recognize how crucially important the issue of credit and capital flows is, and recognize the unmistakable impact of these capital flows and credit flows on interest rates, inflation, and the economy. Therefore, we have got to roll up our sleeves and get down to work and develop a rigorous and analytical framework based on real-world experience. That is the task ahead of all of us who are involved in this credit process.

---

[1] See p. 382.

Senator **Gorton**. Senator Andrews?

Senator **Andrews**. One final question on an area that has to do with credit and interest again.

MORE AT STAKE THAN INTEREST SUBSIDIES FOR STUDENT LOAN PROGRAM

In regard to your statement where you talk about the interest subsidies that go to the student loan program, I think there is a lot more at stake here than just the interest subsidies for the student loan program. When I served under the Johnson administration, there was a lot of concern about the quality of education in America and about the availability of education in America. The Russians had put their space satellite up and we were engaged in catching up. We were spending money right and left to build college buildings and to subsidize teachers and all of the rest.

Then, about 5 or 6 years later, there came the pitch from those of us who were considered moderate on the Appropriations Committee to go in a little different direction, and instead of subsidizing the institutions, in effect, help stimulate the ability of the students themselves; that is, the student loan program. And we began putting our chips there, saying that this would allow the individual students to pick the school that they wanted to go to, and allow them to choose whether this was the place that the education was being offered.

Now, we have an administration that campaigned on the basis of individual determination, et cetera, et cetera, coming up and cutting back the very program in education that allowed the individual students to pick the place they wanted to go and kept in mind the overall goal of this Nation to give a better quality education to more of its people.

In the attack on the student loan program, does this mean that the administration is moving back to the point where we feel that we ought to have direct subsidies to the teaching institutions instead of giving the freedom of choice to the students, or does it mean that the administration has suddenly decided that we do not have to be concerned about extending the quality of education to more and more young Americans?

You cannot just look at the student loan program as a small part. It is an integral change in the overall direction of this country. You attack the program as bad; yet, it was a far cheaper way of getting education for more tens of thousands than the other means that we have tried.

Mr. **Kudlow**. Well, two brief points on that Senator. First, the national goal of improved education for the largest possible number of individuals is very much a part of the Administration's education policy. Having said that, I think in today's circumstances, with financial imbalances, difficult interest rate conditions, and a weak economy, it behooves us to examine very carefully the manner in which we meet this national goal of improved education.

Many people question whether the Federal Government subsidy program is the best way to achieve this goal. This questioning process, as you can understand is particularly acute during the present budgetary crisis, in which we face greater constraints on our financial resources more than at any other time in our Nation's history.

The recommendations from the administration for reductions in student loans were made with an eye toward improving the budget outlook and reducing Federal borrowing and credit demands, certainly not with an eye toward impairing the education process.

We are trying to balance the fiscal responsibilities we have as a nation with the educational responsibilities we have as a nation.

NOTHING TO TAKE THE PLACE OF PRESENT PROGRAM

Senator Andrews. But these are, again, the confused signals that you send out, because you say that this administration has not backed away from the goal of excellence of education and availability of education to those who could not otherwise afford it but would be competent students. Yet, it is attacking the one program that has done more to make education available to competent, though underfinanced students, and is not putting—and I think this is the key and significant thing—not putting anything else in its place.

You say you have got the goal of quality education. You knock out the very program that is bringing such education to our students without putting something else in place.

Mr. Kudlow. We may have a philosophical difference on this, but as a general matter, the administration does not feel that Government programs are necessarily the most efficacious process of achieving national priorities. Indeed, as you know, the President himself has argued many times that in so many instances the Government may turn out to be the problem rather than the solution.

Although I am not an expert in education, I feel as a broad budgetary matter that guideline may be as operable in this area as it is in so many others.

Senator Andrews. You would have a difficult time making that statement fly with the college-qualified, brilliant young daughter of a sharecropper family. You cannot have it both ways, and that is the concern that we have.

Thank you, Mr. Chairman.

Senator Gorton. Thank you both very much. We do have three additional witnesses.

Dr. Rivlin, thank you for being with us this morning and for being so patient. Again, we would appreciate it if you would summarize your testimony so that we will have a maximum opportunity for questions.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. Rivlin. I would be delighted to, Mr. Chairman, and I am very pleased to be here. As you know, the Congressional Budget Office has emphasized for some time the importance of Federal credit, of having a good grasp of what is happening in the credit area, and of strengthening the budget process with respect to the control of credit.

Federal credit activities have grown very rapidly, in part, I think, because of the budget process itself. To the extent that the budget process has limited direct spending, it has created an incentive to use credit mechanisms rather than direct spending to accomplish Federal purposes.

Federal credit has strong impacts on capital markets, and in this regard I would like to add to the general emphasis of the earlier part of the hearing. In the view of the Congressional Budget Office, the size of the deficit does matter, and Federal credit, particularly off-budget lending, enhances the problem, although in a not very visible way. The activities of the Federal Financing Bank in lending off-budget add about $20 billion to the visible deficit.

CONGRESSIONAL CONTROL OF CREDIT LIMITED UNTIL RECENTLY

Until very recently congressional control of credit, not only through the budget process but in general, was extremely limited. Until 1980, many credit programs were not given annual directives regarding the level at which they could operate. Direct loans were counted in the budget net of repayments, a practice that obscured the actual volume of lending for many programs. Off-budget direct loans were, and still are, excluded from budget totals, and these loans created an unrecognized and large deficit. Loan guarantees were explicitly excluded from the budget totals in the congressional budget process.

Over the last couple of years, however, the budget committees have taken credit seriously. They have looked at a total credit budget, have voted on it, and have demonstrated that credit can be measured and that it can be brought into the regular budget process.

During this time, the Congressional Budget Office has improved its capability to monitor action on credit programs. We have developed an automatic credit scorekeeping system that can compare congressional action on credit programs against the functional targets established in the concurrent resolutions.

We will shortly begin to issue credit budget statements as part of all cost estimates for bills affecting loan or guarantee programs. We are also developing the ability to make independent 5-year projections and reestimates for the credit budget as we now do for the unified budget.

INCORPORATE CREDIT ACTIVITIES INTO BUDGET PROCESS

Two years of experience with informal credit budgeting has, I think, served to increase the general awareness of the importance of Federal credit activities and to develop supporting services to monitor these activities. An official credit budget would now be relatively easy to implement. Hence, the next logical action in increasing congressional control over Federal credit programs is to incorporate credit activities fully into the budget process. This would involve several steps: making credit totals binding and subjecting credit bills to points of order if their totals violate the budget aggregate; writing reconciliation instructions for the credit budget; requiring appropriation actions on all credit programs; and incorporating credit programs into the Impoundment Control Act of 1974.

The procedures used up to this point have been informal, but now I think it would be sensible for the Congress to take more formal steps. Each of the procedures I have listed could contribute toward making the budget process a more effective vehicle, and there are bills before both Houses that would do this—the Mineta-Bethune bill in the House and the Percy bill in the Senate. This would not make life easy; it would simply make Federal credit part of the already difficult process of deciding how resources should be allocated.

ADDRESS PROBLEM OF OFF-BUDGET NATURE OF MUCH OF CREDIT

These steps, I think, are the next logical ones, but they would not solve all the problems, as you know. The problem of the off-budget nature of much Federal credit would remain, and I think that should also be addressed in due course.

There are various approaches to the off-budget problem. One possible solution would be to abolish the Federal Financing Bank, but I do not think that would be sensible; the FFB plays a useful role. Another approach would be to put the FFB on-budget, but this would have the drawback of forcing the FFB to establish priorities by selecting which agencies to assist within its budget totals. As Mr. Mehle pointed out earlier, that is really not the role of the FFB.

Hence, I think the best approach would be to require the agencies initiating FFB transactions to keep the resulting outlays on their books. Such a change would increase the unified budget totals and the deficit by the amount of FFB lending. It would not alter the actual state of Federal finances, but rather would reflect that state more accurately. At the request of this task force and the House Budget Committee, CBO will soon publish a paper examining the FFB question in greater depth.

Finally, Mr. Chairman, looking down the road, it seems to me that a further step would help solve the problem more completely; namely, restructuring the Federal budget itself so that it shows clearly the three categories of spending, lending, and loan guarantees extended, and shows them gross, not net, as is now done. You could also show, on the revenue side, the comparable items—tax receipts, repayments, and the ends of guarantees.

That would clean up the budget and allow you to see more clearly the various ways in which the Federal Government influences economic activity.

Thank you, Mr. Chairman.

Senator GORTON. Thank you, Dr. Rivlin.

PREPARED STATEMENT OF ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to appear before this Task Force to discuss the importance of improving the budgetary treatment of federal credit activities. After two years of experience with an informal credit budget, I believe the Congress is ready to make credit budgeting an integral part of the Congressional budget process. My testimony covers three areas:

- The recent growth of federal credit and its probable impact on credit markets and the economy;
- The progress of Congressional efforts to improve credit budgeting; and
- Needed next steps in credit budgeting.

GROWTH IN FEDERAL CREDIT ACTIVITIES: CAUSES AND EFFECTS

In the last decade and particularly during the past six years, federal credit programs--direct loans and loan guarantees--have been growing faster than direct spending programs. Since 1976 federal credit has grown at a rate of 27 percent per year, more than doubling every three years. By contrast, during the same years budget outlays rose at a rate of about 12 percent annually. Consequently, credit programs account for an increasing proportion of all federal financial assistance. By fiscal year 1980, one of every eight dollars extended by federal agencies was in the form of a direct loan or loan guarantee. The volume of loans and loan guarantees outstanding had climbed to $462 billion, a figure two-thirds as large as the federal debt in 1980.

During these years, the types of activities funded through credit programs have also increased. Programs have been developed in new areas: synthetic fuels commercialization and aid to large individual ventures, such as New York City and the Chrysler Corporation. At the same time, programs in the traditional areas have continued to expand and diversify: housing, agriculture, business assistance, and international development.

Causes

Although the reasons for the surge in federal credit during the 1970s are not fully understood, several contributing factors deserve special notice. First, the largest share of guaranteed loans, and an important portion of direct loans, serve the housing market. The lack of available private mortgage funds in recent years has created greater demand for federally assisted funding, and spiraling housing prices have necessitated larger loans and guarantees than previously required. These factors have resulted in an increase in the single largest credit program—FHA mortgage insurance--from $2.3 billion in net guarantees in fiscal year 1976 to $14.4 billion in 1980.

Second, increasing market interest rates in recent years have opened a large gap between the interest rates offered by many fixed-rate federal loan programs and those available to borrowers through private institutions. This has increased demand for federal low-interest loans, which are now heavily subsidized. Some of this increased demand probably has been accommodated by higher program levels. This is certainly a factor in the explosion of the Guaranteed Student Loan Program, with interest rates pegged at 7 percent until 1980 and open-ended eligibility.

Two other factors in the growth of federal credit relate to changes in its budgetary treatment. In 1974 the Federal Financing Bank (FFB) began operations, allowing some federal agencies to transform their on-budget direct loans into off-budget loans and others to transform guaranteed loans into off-budget direct loans. This opportunity to lend federal funds without adding to budget costs may certainly have encouraged higher lending levels by those agencies able to use the FFB.

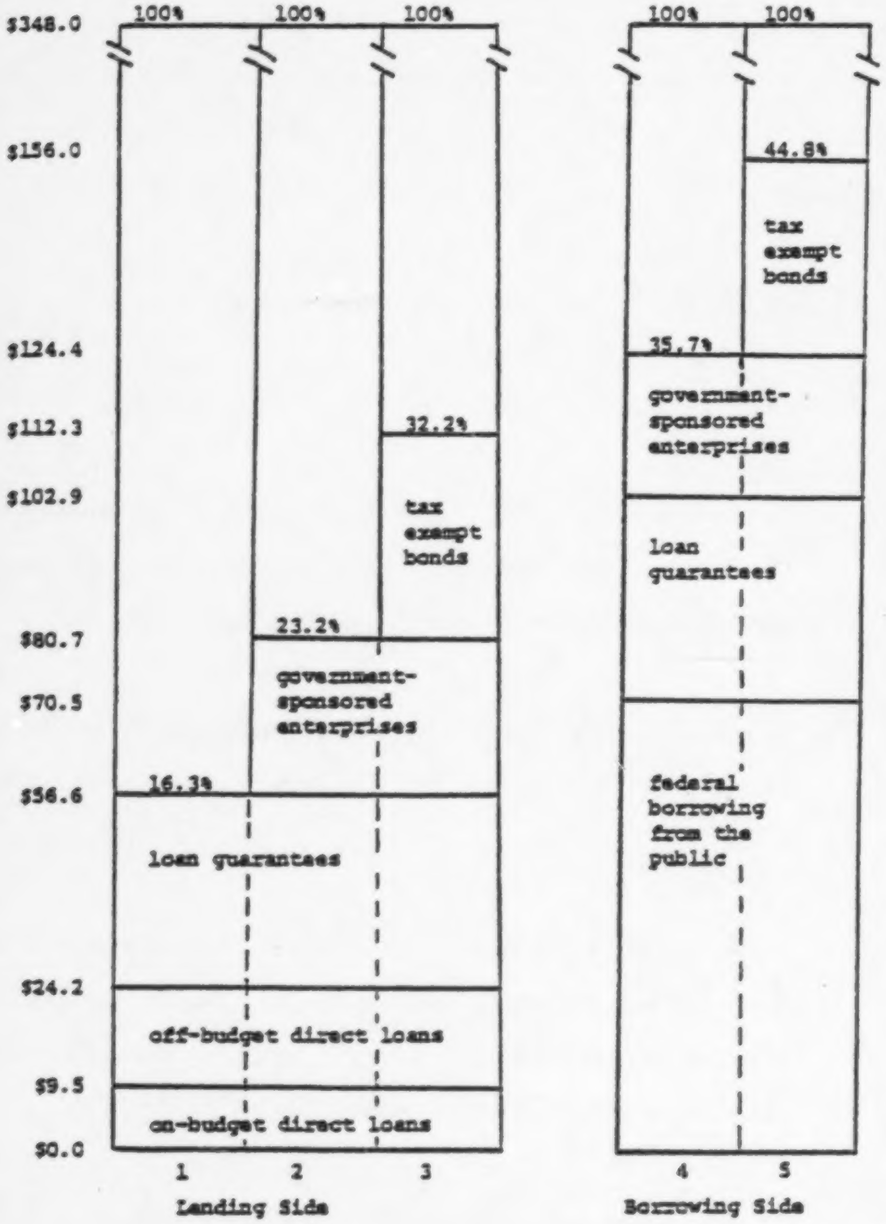
Also in 1974, the Congressional Budget Act was passed. This act placed tighter controls on Congressional action on all forms of federal spending with the exception of loan guarantees, which were specifically excluded from its coverage. The change in severity of controls over direct spending relative to loan guarantees may have prompted an increasing use of the guarantee mechanism. Undoubtedly, the lower budget visibility of credit programs contributed substantially to the spurt in federal credit.

Economic Effects of Federal Credit in Capital Markets

The federal government now makes heavy demands on credit markets in several ways—direct loan and loan guarantee programs; borrowing by government-sponsored enterprises; bonds for local industrial and housing development subsidized through federal tax exemptions; and, of course, financing the budget deficit. Figure 1 shows the size of these forms of borrowing relative to total funds raised in domestic credit markets. In fiscal year 1980, the year of the most recent available data, these activities absorbed 45 percent of total credit in the nation's capital markets (see column five of Figure 1). Such large federal demands on capital markets raise the possibility that a large amount of private credit may be "crowded out." Risk-free, federally assisted credit is given first preference in the queue for the relatively inelastic supply of funds in credit markets. The high volume of new federally assisted borrowing may also contribute to the sustained high interest rates of recent years.

Among the varieties of federally assisted credit, direct loans and loan guarantees, which account for 16 percent of all funds advanced in the economy (see column one of Figure 1), merit special attention for two reasons. First, many of the loans are heavily subsidized. Subsidized credit displaces credit that would have been spent on activities considered more profitable by market standards. If this were not so, the market would have allocated credit to the uses favored by the government without federal intervention. By diverting resources from more to less productive uses, subsidized credit programs can reduce the efficieny of the nation's capital stock. And because increases in overall productivity depend on the effective use of capital, subsidized credit may retard national productivity growth. In particular cases, of course, the benefits of subsidized credit programs may well outweigh the costs. Nevertheless, the potentially large economic costs of federal credit activities call for continuous review and assessment by the Congress.

FIGURE 1. FEDERAL PARTICIPATION IN DOMESTIC CREDIT MARKETS, FISCAL YEAR 1980 (Expressed as percent of total funds in credit markets, dollars in billions)



Source: Budget of the U.S. Government for Fiscal Year 1982, Special Analysis on Federal Credit Programs.

Second, the failure to account fully for credit programs in the budget gives them an inappropriate advantage over direct spending programs. Improved budgetary oversight of loan and loan guarantee programs could enable the Congress to monitor their use and growth in a way that would consider federal priorities as well as the needs of national credit markets. Fortunately, better control of these programs is now within our reach.

THE CREDIT BUDGET

Three principles form the foundation of good credit budgeting:

- Congressional Control. The budget process should enable the Congress to make informed choices, specifying both individual program levels and the volume of total credit activities.

- Comprehensive Coverage. The budget and budget process should include all forms of federal financial activity. Nothing should be hidden.

- Accuracy of Information. The budget should present the Congress and the public with information about all federal programs that is clear, accurate, and includes measures of both volume of activities and long-run costs.

Until 1980, the following deficiences in the budgetary treatment of credit violated all of these fundamental goals of good budgeting:

- Many credit programs were not given annual directives on the level at which they could operate.
- Direct loans were counted in the budget only net of repayments, a practice that obscured the actual volume of activities for many programs.
- Off-budget direct loans were—and are—excluded from budget totals. These loans create an unrecognized federal deficit, which is expected to add $20 billion to federal borrowing in 1982.
- The budget totals and the Congressional budget process explicitly excluded loan guarantees.

Before the improvements of 1980, not only did the budget understate the governmental costs of federal credit activities, but it virtually ignored the perhaps even greater costs to the economy at large. The inadequate treatment of federal credit activities contributed to a perception of credit as close to a free good, and enabled many programs to grow without explicit Congressional approval.

Since the fiscal year 1981 budget, the Congress and the Administration have adopted an informal credit budget that functions in tandem with the unified budget to enhance control of total direct loan and loan guarantee levels in all credit programs. This credit budget has two major components: inclusion of credit targets in the concurrent resolutions on the budget and annual limitations on gross activity levels for credit programs in appropriations bills.

In terms of the three budgeting objectives discussed above, the most significant achievement of the new approach has been the annual limitations applied to many credit programs for the first time. This represents a step forward in Congressional control. The budget resolution credit targets have improved Congressional and public understanding of the overall volume of federal credit and its claim on the financial resources of the economy.

The two Budget Committees and the Congressional Budget Office now have the capability to monitor action on credit programs at each stage of the authorization and appropriation processes. CBO has developed an automated credit scorekeeping system that can compare Congressional action on credit program bills against the functional targets established in the concurrent resolutions. CBO will shortly begin to issue credit budget statements as a part of all cost estimates for bills affecting loan or guarantee programs. We are also developing the ability to make independent five-year projections and reestimates for the credit budget, as we now do for the unifed budget.

The two years of experience with the informal credit budget have served to increase general awareness of the importance of federal credit activities and to develop supporting services to monitor these activities. An official credit budget would now be relatively easy to implement.

NEXT STEPS IN CREDIT BUDGETING

The next logical step in increasing Congressional control over federal credit programs is to incorporate credit activities fully into the Congressional budget process. The significant changes from the informal procedures used for the past two years could be the following:

- Make credit totals binding;
- Subject credit bills to points of order if their totals violated credit budget aggregates;
- Write reconciliation instructions for the credit budget;
- Require appropriations action for all credit programs; and
- Incorporate credit programs in the Impoundment Control Act of 1974.

The procedures used in establishing a credit budget thus far have been agreed to informally. Credit has been included in the budget resolutions using the authority of Sec. 301(a)(6) of the Budget Act. That section provides for the inclusion of "such other matters relating to the budget as may be appropriate . . ." The shift to a formal credit budget might be taken more seriously if the Budget Act is formally amended. Senator Percy has introduced a bill to make such changes.

Each of these new procedures would contribute importantly towards making the budget process a more effective vehicle. They would eliminate the current budgetary advantage of credit programs over direct spending and give the Congress explicit control over aggregate credit levels. A framework would be provided within which the Congress could consider the appropriate level and allocation of credit among the many programs competing for limited federal resources.

Making these decisions would not be easy, especially without concrete information about the economic effects of credit programs. But neither was it easy to decide the total level of federal spending and revenues in the concurrent budget resolutions when they were first introduced in 1975 and 1976. Nor is it easy today. Our understanding of the economic effects of spending and tax proposals is not as complete as we would like it to be, and the Congress would face even greater uncertainties in debate over credit levels. But only binding Congressional action on aggregate credit levels can create the attention needed to inspire the research that will improve understanding.

Remaining Problems

Although the improvements just discussed would be an important advance in strengthening the Congressional credit budget, they would not completely solve the inadequacies in the budgetary treatment of credit I described earlier. There is a need to bring off-budget credit activities on budget, to restructure the whole budget to distinguish among the economic effects of various federal activities, and to improve Congressional control.

Revising the Budgetary Treatment of the FFB. The off-budget status of the Federal Financing Bank will understate the budget deficit by approximately $20 billion in fiscal year 1982. The bank, in fact, acts as an off-budget lender for on-budget agencies. By purchasing loans and certificates of beneficial ownership (pools of loans called CBOs) from on-budget agencies, the FFB transfers on-budget loans to off-budget status. The FFB also acts as a primary lender at the request of various on-budget federal agencies. The FFB makes direct loans to borrowers, at interest rates only marginally above the cost of Treasury borrowing, whenever the agencies guarantee the full repayment of interest and principal in the event of default by the borrowers.

The distinction between on- and off-budget credit programs is thus virtually meaningless—except with respect to the unified budget deficit. Although the Congress currently exercises no control over the timing or amounts of off-budget financing of direct loans by the FFB, it cannot escape its consequences. The ceilings on the public debt must be increased for each dollar of net lending by the FFB. Even with a balanced budget, the public debt ceiling would still have to be increased because of the FFB's off-budget lending.

One possible solution to the understatement of the deficit presented by off-budget lending would be simply to abolish the FFB. This action would, however, eliminate the benefits provided by the FFB—coordinating federal borrowing and reducing total federal borrowing costs.

Another approach would be to put the FFB on budget. This, however, would have the drawback of forcing the FFB to establish priorities by selecting which agencies to assist within its budget totals.

The best approach would be to require the agencies initiating FFB transactions to keep the resulting outlays on their own books. Such a change would increase the unified budget totals and deficit by the amount of FFB lending. This would not alter the actual state of federal finances, but rather would reflect that state more accurately. At the request of this Task Force and the House Budget Committee, CBO will soon publish a paper examining the FFB question in greater depth.

Budget Restructuring. Finally, let me describe a more drastic solution to credit budgeting problems. If we were to start afresh and devise a budget that would accurately report the nature of federal financial transactions, the following picture might emerge. The three types of aid extended by federal agencies would be recorded separately and completely: direct spending, direct loans, and loan guarantees. On the revenue side, each of these would be matched against its source of offsets: taxes, loan repayments, and expiring guarantees. Attention would be directed not towards one budget deficit of ambiguous interpretation, but towards two or more clear-cut measures—deficit spending and net credit extensions being the most important. If the budget were restructured along these lines, our three budgeting objectives would essentially be fulfilled:

- Congressional Control. Under the present system, action on credit programs occurs both in the unified and credit budgets, though in different forms. Restructuring the budget would focus all attention on credit in one place.

- Comprehensive Coverage. Restructuring the budget would solve the off-budget problem, and would do so without creating one large deficit.

- Accuracy of Information. All measures relevant to credit program evaluation would be displayed clearly: gross activity, net additions to outstanding credit, and expected direct costs.

Restructuring the budget would not require a change in law, but rather agreement between the Congress and the Administration on budget concepts. A study commission similar to the 1967 Budget Concepts Commission would probably be the best way to begin the task. Such a commission could also examine other issues in the budget process. Tax expenditures immediately come to mind.

CONCLUSION

The Congress has made substantial progress in improving its review of federal credit activities. I encourge this Committee to take the next steps. First, the credit budget should be fully implemented, within the context of the current Congressional budget process. Next, the misleading impact on the deficit of off-budget lending should be corrected. Finally, the Congress should initiate a review of the entire budget structure in an attempt to allow comparable treatment for spending, lending, and tax expenditures.

Senator GORTON. We are very dependent on the figures and the statistics which you provide to this committee, and I am most appreciative of the constructive and imaginative thought which you have put into this very real problem and to attendant problems of improving the Budget Act.

LOAN GUARANTEES DIFFER FROM DIRECT TREASURY BORROWING

The two previous witnesses made the statement that loan guarantees have essentially the same effect as direct Treasury borrowing. Do you agree with that statement?

Dr. RIVLIN. No. I think they are different, although I think both must be considered. Loan guarantees are a more indirect way of affecting activity.

Senator GORTON. In a time of high interest rates and tight money, as a general proposition would you consider it more appropriate to increase or decrease the aggregate level of Federal credit assistance? And there is a related question: What kind of effect do you believe this activity has on interest rates and the growth of money supply, and particularly interest rates for nonfederally guaranteed or supplied credit?

Dr. RIVLIN. The purpose of a Federal credit program is to affect the allocation of credit in some way. When such programs were enacted, it was thought that a certain class of borrowers did not have sufficient access to private credit markets, and that the Federal Government should help in some way.

There is a limited supply of funds to be borrowed, and any Federal credit program tends to direct borrowing, from some other use to a favored use. To that extent, it may well reduce the overall efficiency of the economy by directing credit away from where it would flow in an ordinary market situation. That may be worth doing, of course, but we should be aware of what is happening.

The extension of Federal credit in the aggregate, especially if the Federal Government is borrowing in order to do this, is the other side of the coin. The Federal borrowing puts upward pressure on interest rates and makes it more difficult for everybody else to borrow.

Senator GORTON. Do you have a study that would indicate or give us any formula to make a determination as to how much pressure or what impact it has on interest rates?

Dr. RIVLIN. There are studies that have attempted to look at this; they are very inconclusive. I think we know the direction, but it is very hard to estimate the magnitude.

MAJOR FEDERAL CREDIT PROGRAMS LOOKED AT CASE-BY-CASE

Senator GORTON. I would like to ask you the same question I asked the two previous witnesses. Obviously, as you have outlined, Federal credit assistance is justified on the grounds of market failure. Do you have either an opinion or a formula for determining an answer objectively as to which sectors of the economy have a particular need for Federal credit assistance?

Dr. RIVLIN. I think that has to be examined case by case, and we are looking, in a publication which will be forthcoming in January, at a number of major Federal credit programs, case by case. I do not think there is a formula. One has to know a good deal about the market.

For example, when the Federal Government moved into the housing market in the 1930's and 1940's it was very difficult for individuals to get mortgages through the ordinary processes of the private credit market. It is not clear that that is true anymore.

Senator GORTON. Senator Quayle?

Senator QUAYLE. I do not have any questions.

Senator GORTON. Do you have an opening statement?

Senator QUAYLE. I think you are getting into an area that needs to be seriously addressed. I thank this witness for her insight and input. We have had some discussions on reforms in the budget. I know that this is one that Dr. Rivlin feels quite strongly about and is of great value to us.

There is another reform that she and I have talked about as far as a comparison between a 1-year budget and a 2-year budget process, and even more. We do not need to get into that now, but that is certainly another area.

I think it is appropriate and proper for the Budget Committee itself to begin to look at the so-called process that we have. I would hope that we would be able to make some progress toward reforming the process that is, in my opinion, simply inadequate.

Let me just ask one question predicated on that statement. What would be the most realistic objective on the credit control aspect that we as a committee and a Congress should pursue this next year?

What would be the most significant accomplishment that we could make?

CREDIT TOTALS SHOULD BE BINDING AND SUBJECT TO POINTS OF ORDER

Dr. RIVLIN. I think that on credit the next steps are fairly clear. You should formalize what you have already been doing. The credit totals, I think, should be made binding and subject to points of order. I think that would be the first step to take to make the credit budget really effective.

Senator QUAYLE. Making it binding and subject to a point of order?

Dr. RIVLIN. That is right. That would be accomplished in the Percy bill.

Senator QUAYLE. And then what would be the natural add-on or follow-on to that?

Dr. RIVLIN. Well, other features of the Percy bill would be—and I think they are the right ones—to make it possible to write reconciliation instructions for credit as well as for spending programs, and to include loan guarantees in the impoundment provisions. That would really be sort of cleaning up the Budget Act to make it consistent, so that it would apply equally to credit and to direct spending.

I think the next most important step would be to deal with off-budget lending and to decide what to do about the Federal Financing Bank in order to bring that lending on-budget so you can see it.

Senator QUAYLE. Thank you, Mr. Chairman.

Senator GORTON. Thank you, Dr. Rivlin. We appreciate having had you with us, and you will assist us in a major part of the process as we go forward.

Dr. RIVLIN. Thank you.

Senator GORTON. The Honorable Nancy Teeters, member of the Board of Governors of the Federal Reserve.

Please proceed.

STATEMENT OF NANCY H. TEETERS, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Ms. TEETERS. I would like to submit my entire statement for the record.

Senator GORTON. It will be placed in the record in full, and we would appreciate your summarizing it for us.[1]

Ms. TEETERS. Mr. Chairman, it is a pleasure to be here today to present the views of the Federal Reserve Board on the impact, budgeting, and control of federally assisted credit. This is a particularly appropriate time to consider such issues. Given the serious inflation problems currently plaguing our Nation, it is imperative that growth in money and credit be held to a moderate pace. Within this context, every effort should be made to insure that

---

[1] See p. 64.

Federal credit activities as well as Federal spending are carefully evaluated in order to avoid creating serious distortions in financial markets.

Indeed, it would be most inappropriate for off-budget Federal loan programs and loan guarantees to provide a less conspicuous substitute for direct on-budget Federal spending at a time when strenuous efforts are being made to bring the growth of spending under control.

BUDGETARY CONTROL OF FEDERAL CREDIT ACTIVITIES SHOULD BE CONSIDERED

Although the economic and credit market consequences of Federal loans and loan guarantees are not in all cases the same as those of deficit-financed Federal spending, there are enough similarities to warrant parallel procedures for budgetary review and control. I shall argue, therefore, that formal procedures for budgetary control of Federal credit activities should be given careful consideration.

Furthermore, I shall renew my earlier recommendations for establishment of a new budget commission to analyze the appropriate accounting for Federal credit programs, and for continuing analysis and evaluation of the appropriate tools—direct spending, loans, loan guarantees, or tax expenditures—for achieving alternative program objectives.

I would like to turn to my statement and talk about budgetary controls of Federal credit. As you know, congressional review and control of Federal credit activities have been evolving over time. The utilization of the unified budget concept begun in 1969 is one of the noteworthy watersheds.

At that time, the Government adopted, for control purposes, a budget framework that was in most respects a cash accounting system. In making this choice, it was decided after considerable debate to include the net outlays of all direct lending programs on budget. This new approach, however, was uncomfortably silent on how Federal loan guarantees were to be treated.

In the early 1970's, moreover, there was some backsliding from the comprehensive coverage of the unified budget, as a number of agencies were removed from the budget and newly established agencies were accorded off-budget status.

Furthermore, the advantages for orderly marketing of Federal debt gained through the creation of the Federal Financing Bank in 1974 had an unfortunate side effect. Since the FFB's activities have been off-budget from the outset, its acquisition of loans is not reflected on the budget.

Accordingly, the budgetary scrutiny intended to apply to direct loan programs as a result of the comprehensive coverage of the unified budget tended to be eroded. And agencies that made direct, on-budget loans to the public were able to sell these loans to the FFB, thereby enabling them to extend new loans without constraint.

STEPS TAKEN TO IMPROVE CONTROLS OF CREDIT PROGRAMS

In recent years, this erosion process has begun to turn around. A number of important steps have been taken to make coverage of the unified budget more comprehensive and to improve controls of credit programs.

In addition to incremental improvements in budget coverage, major strides have been taken in the development of a separate credit budget process. In the past 2 years, totals have been calculated and presented in the budget for gross new direct loan obligations and new loan guarantee commitments. Components of the credit budget total have been shown in respective budget functions and have been subdivided by agency and program in the special analysis.

Also, the outlays of the FFB—direct loans and loan-asset purchases—are now attributed to the originating agency, which in my view eliminates the tendency for the operation of the FFB to obscure the nature of credit programs. A final important step taken by the Congress last year was to have the budget resolution include target ceilings for total new obligations and total new guarantee commitments, and to distribute these totals by budget function.

Both the past and the current administrations have also proposed that a substantial proportion of the credit budget totals be made subject to annual appropriations limitations. The January budget proposed that 63.8 percent of the credit budget for fiscal year 1982 be so limited.

Those programs exempted are limited to unambiguous entitlements that cannot be effectively limited by appropriations; programs that provide for unforeseeable contingencies, such as deposit insurance; guarantees of certificates of beneficial ownership that are sold by the Farmers Home Administration and Rural Electrification Administration; and a catch-all of programs, such as export promotion loans by the Commodity Credit Corporation. That final area of exemption, in particular, deserves careful reevaluation by Congress.

FORMALIZE A CREDIT BUDGET PROCESS

Broadening the coverage of the unified budget and the formulation of a separate but parallel credit budget sets the stage for a number of further steps in implementing an effective process to bring credit programs under systematic review and control. One logical next step might be to formalize a credit budget process with enforcement procedures. The Federal Reserve Board, in general, enthusiastically endorses the formalization of some credit budget process such as that implemented on an experimental basis last year.

It is the Board's view, however, that legislation that contains measures pertaining to appropriations limitations should be very carefully approached. Such limitations are, of course, central to the budgetary control process proposed by the last administration and endorsed by the present administration.

However, exemption of at least some emergency assistance and entitlement programs appears warranted. If legislation applying such limitations is contemplated, the Board therefore suggests that all emergency assistance and entitlement programs be exempted, at least until more experience is gained with a formal budget process and until a case-by-case review of these programs can determine the possible difficulties or advantages of applying appropriations limitations to them.

The exemption of entitlement and emergency assistance programs from appropriations limitations need not imply changing the current procedures whereby legislation creating or expanding entitlements is referred to the Appropriations Committee for review.

The Board's recommendation that entitlements and emergency assistance programs be exempted from binding appropriations ceilings is intended only to promote the effective operations of those programs thought by the Congress to be worthwhile, even in the event of unanticipated demands upon them resulting from natural disasters or unforeseen events.

Although enactment of legislation to apply a formal budget process to credit programs would go far to bring order into the Federal credit program scene, there are other steps that I would like to recommend.

END HAPHAZARD WAY SOME LOAN PROGRAMS ARE INCLUDED IN THE UNIFIED BUDGET

One is a systematic review of the treatment of Federal credit programs in the unified budget. The current haphazard situation, in which some loan programs are included in the unified budget and others are not, should be ended.

A careful analysis should be undertaken of the question of whether or not the principal amount—net—of all direct loans should be included in the unified budget and whether, if the principal amount of direct loans is excluded as I am inclined to prefer, the amount of the implicit or explicit interest subsidy should be placed on budget.

Similarly, a comprehensive review of guarantee programs would be desirable in order to determine whether the potential subsidy or future outlay for defaults is taken appropriately into account. I have previously called for the establishment of a new budget commission which would be charged with analyzing and resolving these questions. In my view, the passage of time has not reduced the advisability of establishing such a commission.

Finally, I recommend to this committee a continuing evaluation of the extent to which direct spending, direct loans, loan guarantees, or beneficial tax treatment can most effectively be used to achieve particular program objectives and the extent to which, in particular budget functions, there may be duplicative and excessive use of these various approaches.

The budget process has come a long way in providing the accounting framework and legislative process needed to address such questions. I am looking forward to further progress and I am sure that the work of this committee will contribute to it.

I would be happy to answer any questions.

Senator GORTON. Thank you, Ms. Teeters.

PREPARED STATEMENT OF NANCY H. TEETERS, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. Chairman, it is a pleasure to be here today to present the views of the Federal Reserve Board on the impact, budgeting and control of federally assisted credit. This is a particuarly appropriate time to consider such issues. Given the serious inflation problem currently plaguing our nation, it is imperative that growth in money and credit be held to a moderate pace. Within this context, every effort should be made to insure that federal credit activities as well as federal spending are carefully evaluated in order to avoid creating serious distortions in financial markets.

Indeed, it would be most inappropriate for off-budget federal loan programs and loan guarantees to provide a less conspicuous substitute for direct, on-budget federal spending at a time when strenuous efforts are being made to bring the growth of spending under control. Although the economic and credit market consequences of federal loans and loan guarantees are not in all cases the same as those of deficit financed federal spending, there are enough similarities to warrant parallel procedures for budgetary review and control. I shall argue, therefore, that formal procedures for budgetary control of federal credit activities should be given careful consideration. Furthermore, I shall renew my earlier recommendations for establishment of a new budget commission to analyze the appropriate accounting for federal credit programs, and for continuing analysis and evaluation of the appropriate tools--direct spending, loans, loan guarantees or tax expenditures--for achieving alternative program objectives.

Growth of Federal Credit Programs

Mr. Chairman, federal credit programs have expanded enormously, both in amount and in scope, in recent years. The total volume of outstanding direct loans and loan guarantees, for example, has been projected to total over $540 billion by the end of the fiscal year which ended in September. This is nearly triple the $190 billion level reached just 10 years ago. In addition, the volume of loans held by government-sponsored agencies was projected to total about $170 billion at the end of fiscal year 1981, up $20 billion from last year and more than four times the level of 10 years earlier. In fact, their growth has been much larger than anticipated, principally due to increased demands on the Federal Home Loan Banks.

Federal credit activities, moreover, are likely to continue to grow rapidly in the years ahead unless deliberate efforts are made to constrain them. The January budget projected that net credit advanced under federal auspices—direct, guaranteed and sponsored--would total over $100 billion during fiscal year 1982. The Administration's March Budget Revisions for FY1982 called for a significant reduction in loan obligations and guarantee commitments, and further sizable reductions in loan guarantee commitments were recently announced. Even so, if total credit flows in the coming years were roughly to match those of the past year, funds raised under federal credit auspices will account for well over one-quarter of the total net funds raised by nonfinancial and financial borrowers in domestic credit markets.

The widening range of economic activities assisted by federal programs is also noteworthy. In the late 1950s, the home mortgage guarantee programs of the Federal Housing Administration and the Veteran's Administration accounted for 90 percent of the total volume of guaranteed and insured loans outstanding. This proportion has since trended down, and was expected to have been about 73 percent at the end of the last fiscal year, mainly because of an expansion of loan guarantees into new areas--such as military sales and student loans.

The provision of federal credit assistance through direct loans and loan guarantees to achieve particular social and economic objectives has been widely recognized as a legitimate and valuable activity. Many credit programs originally were established to correct imperfections in capital markets that denied credit to some groups or made it cost prohibitive. For example, the FHA-insured loan programs were devised during the Great Depression to reduce the risks perceived by lenders. By pooling risks across a large number of loans issued in a standardized fashion, the government program encouraged private lenders to advance credit at a lower cost to borrowers and on less restrictive terms than would otherwise have been possible. Over time, these more liberal terms gained general acceptance among all types of private lenders.

Many other federal credit assistance programs have been introduced over subsequent years to foster social objectives. Increasingly, these programs have involved substantial interest subsidies. According to OMB estimates, the present value of the interest subsidy on new direct loan obligations and commitments to guarantee loans in the fiscal year just ended was estimated to total almost $27 billion. In contrast to the home mortgage area, moreover, the default rate in some of these programs--such as student loans and assistance for low-income housing--has been comparatively high. Thus, the government has had to absorb sizable, and in some cases unanticipated, default losses in addition to the measured interest rate subsidies to borrowers. In the past few years, the federal government has also guaranteed sizable loans to single borrowers that carry a large potential for default.

Impacts of Federal Credit Programs

Since the general purpose of federal credit programs, obviously, is to enable individual borrowers or groups of borrowers to obtain credit which would otherwise be unavailable to them, or only available at a higher cost, it follows that these programs will generally tend to increase credit use by program beneficiaries. Whether this increase will, in turn, result in greater use of credit in the aggregate, and the desirability of such an increase, depends on the characteristics of the particular programs and on the state of the economy at large.

Let me give some examples to demonstrate the differences in the economic effects of federal credit assistance programs. In some cases, programs may serve as close substitutes for deficit-financed, federal spending. Consider, for example, a situation in which the Congress was contemplating expanding the program in which the federal government guarantees debt issued by state and local authorities who then use the proceeds to provide low cost housing to the poor. Many of the end results of such an expansion could be quite similar to those that would be observed if the federal government were, alternatively, to increase its direct spending to undertake the construction of the rental units, and were then to rent space on a subsidized basis. Note that under either approach construction funds would be provided by private investors either through the acquisition of federally guaranteed securities or by acquiring more Treasury securities than otherwise; the same essential type and volume of productive resources would be used to construct the rental units; and low income families would be provided with better housing than they are otherwise able to obtain.

While stressing basic similarities, however, I should also note some important differences. The most important is that loans must be paid back. Thus, if such a program were to grow to a plateau and then remain constant in size, the volume of loan repayments would equal new loans being guaranteed and the net economic effect would be small. Growth in the net volume of guaranteed loans outstanding, however, could have an effect similar to that of deficit spending. In addition, interest paid on the debt instruments issued by states and localities under the program is not subject to federal tax, as it would be on a direct debt issue of the federal government, so net tax revenues would also be reduced by an expansion of the program.

There are, of course, other credit programs which have much less similarity to noncredit federal spending. For example, homebuyers who take out mortgages under federal guarantees could, in most instances, obtain private credit without the guarantee, albeit at a slightly higher rate. Providing roughly equivalent assistance through direct federal spending in this case would require the federal government to give homebuyers only a modest interest subsidy. The small size of this subsidy suggests that net demands on real resources and credit markets are relatively little affected by the guarantee program. Many cases obviously fall somewhere between these two extremes. Compare the effects of direct federal loans and outright grants in-aid. In both cases, beneficiaries gain immediate command over goods and services. The major difference between the two approaches--that in the case of the loan the government obtains a claim on the beneficiary while it does not with the grant--is an important distinction. It is, however, a distinction without substance in those cases where the borrower defaults.

In general, the closeness of the analogy between assistance provided by federal credit programs and deficit-financed direct federal spending appears to depend less on whether the aid in question is provided through direct loans or loan guarantees than on such things as credit worthiness of beneficiaries, the size and riskiness of their undertaking and their relative ability to tap private credit sources on their own.

As in the case of deficit-financed federal spending, federal credit activities may reduce the availability of credit to others who are not program beneficiaries. The extent to which such "crowding out" takes place, however, depends importantly on the state of conditions in the economy and financial markets. During recessionary periods when credit supplies are readily available, credit assistance may work mainly to enable borrowers to obtain additional funds which can be used to increase demands for goods or services. Thus, in these periods the net result of such programs may, to a great extent, promote a more intense use of resources and an expansion of economic activity rather than a transfer of credit (and resulting effective demand) from one borrower to another.

In times when there is less slack in resource utilization and credit market conditions are relatively tight, however, there is a much greater tendency for credit extended under federal auspices to channel loanable funds, and hence command over real resources, toward assisted borrowers and away from others. In other words, just as private borrowers can, at times, be crowded out of credit markets when federal outlays are financed through the issuance of Treasury debt, so can some private borrowers face higher credit costs when other selected borrowers obtain loans with the assistance of the federal government. There need be nothing inherently wrong with the resulting allocation of credit if the federal intervention in credit markets reflects a careful assessment of the market imperfections that the government is trying to overcome and a careful weighing of costs and benefits. Continuous scrutiny of priorities under a credit budget process is important, however, if such balancing of costs and benefits is to be achieved. And such scrutiny is essential in current circumstances when the growth of credit is necessarily limited by anti-inflation policies.

Budgetary Control of Federal Credit Activities

As you know, Mr. Chairman, Congressional review and control of federal credit activities have been evolving over time. The utilization of the "unified budget" concept, beginning with the 1969 budget, is one notable watershed. At that time, the government adopted for control purposes a budget framework that was, in most respects, a cash accounting system. In making this choice, it was decided (after considerable debate) to include the net outlays of all direct lending programs on budget. This new approach, however, was uncomfortably silent on how federal loan guarantees were to be treated. In the early 1970s, moreover, there was some backsliding from the comprehensive coverage of the unified budget, as a number of agencies were removed from the budget and newly established agencies were accorded off-budget status.

Furthermore, the advantages for orderly marketing of federal debt gained through creation of the Federal Financing Bank in 1974 had an unfortunate side effect. Since the FFB's activities have been off-budget from the outset, its acquisition of loans is not reflected on the budget. Accordingly, the budgetary scrutiny intended to apply to direct loan programs as a result of the comprehensive coverage of the unified budget tended to be eroded. And, agencies that made direct, on-budget loans to the public were able to sell these loans to the FFB thereby enabling them to extend new loans without constraint.

In recent years, this erosion process has begun to be turned around. A number of important steps have been taken to make coverage of the unified budget more comprehensive and to improve controls of credit programs. In addition to incremental improvements in budget coverage, major strides have been taken in the development of a separate credit budget process. In the past two years, totals have been calculated and presented in the budget for gross new direct loan obligations and new loan guarantee commitments. Components of the credit budget total have been shown in respective budget functions and have been subdivided by agency and program in the Special Analysis accompanying the budget and in the budget Appendix. Also, the outlays of the FFB (direct loans and loan-asset purchases) are now attributed to the originating agency, which in my view eliminates the tendency for the operation of the FFB to obscure the nature of credit programs. A final important step taken by the Congress last year was to have the budget resolutions include target ceilings for total new obligations and total new guarantee commitments and to distribute these totals by budget function.

Both the past and the current administrations have also proposed that a substantial proportion of the credit budget totals be made subject to annual appropriations limitations. The January budget proposed that 63.8 percent of the credit budget for fiscal year 1982 be so limited. Those programs exempted are limited to: unambiguous entitlements that cannot be effectively limited by appropriations; programs that provide for unforeseeable contingencies, such as deposit insurance; guarantees of certificates of beneficial ownership that are sold by the Farmers Home Administration and Rural Electrification Administration; and a catch-all of programs, such as export promotion loans by the Commodity Credit Corporation, that the last administration believed appropriate not to curtail due to economic circumstances. That final area of exemption, in particular, deserves careful evaluation by the Congress.

Broadening the coverage of the unified budget and the formulation of a separate but parallel credit budget sets the stage for a number of further steps in implementing an effective process to bring credit programs under systematic review and control. One logical next step might be to formalize a credit budget process with enforcement procedures. The Federal Reserve Board, in general, enthusiastically endorses the formalization of some credit budget process such as that implemented on an experimental basis last year.

It is the Board's view, however, that legislation that contains measures pertaining to appropriations limitations should be very carefully approached. Such limitations are, of course, central to the budgetary control process proposed by the last administration and endorsed by the present administration. However, exemption of at least some emergency assistance and entitlement programs appears warranted. If legislation applying such limitations is contemplated, the Board, therefore, suggests that all emergency assistance and entitlement programs be exempted, at least until more experience is gained with a formal budget process and until a case-by-case review of these programs can determine the possible difficulties or advantages of applying appropriations limitations to them. The exemption of entitlement and emergency assistance programs from appropriations limitations need not imply changing the current procedures whereby legislation creating or expanding entitlements is referred to the Appropriations Committee for review. The Board's recommendation that entitlements and emergency assistance programs be exempted from binding appropriations ceilings is intended only to promote the effective operations of those programs thought by the Congress to be worthwhile, even in the event of unanticipated demands upon them resulting from natural disasters or unforeseen economic developments.

Although enactment of legislation to apply a formal budget process to credit programs would go far to bring order into the federal credit program scene, there are other steps that I would like to recommend. One is a systematic review of the treatment of federal credit programs in the unified budget. The current haphazard situation, in which some loan programs are included in the unified budget and others are not, should be ended. A careful analysis should be undertaken of the question of whether or not the principal amount (net) of all direct loans should be included in the unified budget and whether, if the principal amount of direct loans is excluded as I am inclined to prefer, the amount of the implicit or explicit interest subsidy should be placed on budget. Similarly, a comprehensive review of guarantee programs would be desirable in order to determine whether the potential subsidy or future outlay for defaults is taken appropriately into account. I have previously called for the establishment of a new budget commission which would be charged with analyzing and resolving these questions. In my view, the passage of time has not reduced the advisability of establishing such a commission.

Finally, I recommend to this Committee a continuing evaluation of the extent to which direct spending, direct loans, loan guarantees or beneficial tax treatment can most effectively be used to achieve particular program objectives and the extent to which, in particular budget functions, there may be duplicative and excessive use of these various approaches. The budget process has come a long way in providing the accounting framework and legislative process needed to address such questions. I look forward to further progress and I am sure that the work of this committee will contribute to it.

Senator GORTON. Due to the obvious fact that our understanding of the economic effects of Federal credit activities is still relatively elementary, does the Federal Reserve Board have any specific plans for additional research designed to increase that knowledge?

IMPACT OF CREDIT AND CREDIT USE CONTINUALLY RESEARCHED

Ms. TEETERS. We have continuous research on the credit markets and on the allocation of credit. We are the source of the major analysis of credit use, the flow of funds, which is comparable in the credit field to the national income accounts in the macroeconomic field. So, we are in continual research as to the impact of credit and credit use at any time in the economy.

Senator GORTON. So, you intend to keep ongoing projects?

Ms. TEETERS. Absolutely, yes.

Senator GORTON. Can you shed any light on the effect of present Federal credit assistance on interest rates in the nonfavored areas of the economy—those areas which are not eligible for Federal assistance?

Ms. TEETERS. There are some programs which have legislated, very low interest rate ceilings. For example, drought assistance last year, I think, had a 5-percent cap on the interest rate. In other areas, in evaluation of various projects, the legislation tells you what interest rate to use in order to discount it.

It is obvious in those areas that the below-market-rate interest is providing a subsidy to the activity which is receiving the allocated credit. In the case of guarantees, I think you get something below the market rate of interest, but not very much; you have a smaller area of interest subsidy in those cases.

To the extent that it makes less credit available in the nonallocated area, it could conceivably, considering the economic conditions, put upward pressure on interest rates.

Senator GORTON. But you have no way of measuring that or even knowing whether or not it is the case?

Ms. TEETERS. Not directly, no.

Senator GORTON. Senator Quayle?

EFFECTS OF CROWDING OUT

Senator **Quayle**. That was sort of my question. I was reading in your statement:

> As in the case of deficit-financed Federal spending, Federal credit activities may reduce the availability of credit to others who are not program beneficiaries. The extent to which such crowding out takes place, however, depends importantly on the state of conditions in the economy and financial markets.

Does the crowding out have an effect of upward pressure on interest rates?

Ms. **Teeters**. If you are at the top of a boom of the economic cycle, that probably does happen. I think that back in the 1973-1974 period, if we had had a credit budget program, we probably would have delayed some of the Federal credit programs during a period of very stringent monetary policy, which occurred in 1973 and into 1974. They were delayable types of programs, and would have made more room for the private expenditures at that point.

I probably would have been desirable in the first 9 months of this year to have delayed some of the Federal credit-sponsored programs to make more available to the private market. You can shift the timing of these things to some extent.

Now, during periods of recession when the private demands for credit are very low, the possibilities of crowding out obviously go down in direct proportion to the sagging demand for private credit.

Senator **Quayle**. What about the apparent recession we are in now, which is going to continue until, at least most economists I think indicate, the early second quarter? Would it be advisable for the Congress to at least delay or perhaps curtail some of its——

Ms. **Teeters**. The possibility of crowding out comes at the other side of the cycle; it comes at the peak rather than at the trough. At the present time, private demand for credit is dropping quite rapidly because of the recession. Because of that, the possibilities of crowding out in this situation have declined considerably.

When you come back to a full-scale recovery some time down the line, if your credit programs are beginning to expand very rapidly and the economy is heading back toward lower levels of unemployment, you may get the situation where we begin to get tight credit restrictions again, and then you would want the Federal programs to move aside.

Senator **Quayle**. I was a bit remiss. I want to welcome you to the committee. I believe your home town is Marion, Ind.

Ms. **Teeters**. That is right.

Senator **Quayle**. I want the chairman of this committee and the full committee to take proper legislative notice that this is a former resident of the great state of Indiana.

CONTRIBUTION OF DEFICITS TO INFLATION

Let me just ask one other question which is a little bit off the topic. I just would be interested in your perspective as a member of the Federal Reserve Board. There has been a lot of publicity in this town over the question of whether deficits contribute to inflation.

I would just be interested in your analysis of whether deficits do, in fact, play a role in the contribution of inflation.

Ms. **Teeters**. There are two points to this question. I was quite interested to see the revival of an older concept with a new name. I noticed that the administration is now talking about the standardized budget deficit, which has a great deal of relationship to an older concept called the full employment budget surplus.

Basically, they are talking of a number in the newspaper of 109 billion. Some part of that deficit is due to the recession. I am not quite sure of my numbers recently, but approximately an extra percent of unemployment adds about $20 billion to your deficit. Depending on what you consider full employment, you can subtract that portion of it as being the reaction of the economy upon the Federal deficit rather than vice versa.

However, if you standardize for the economic performance, they are running a deficit that would still be there at, say, 5-percent unemployment or even 6-percent unemployment. And it not only is still a deficit, but it becomes deeper in 1984 and 1985. So, even if we get full recovery of the economy, there are going to be substantial deficits in the Federal budget, and those are the ones which I think create the pressure toward inflation.

Now, the second part of the question is, how do you finance the deficit? To the extent that you finance it by monetizing it, which was what we did during World War II—large amounts of the deficit were financed by issuing securities to the Federal Reserve System—you are directly creating money.

But to the extent that it is not financed by selling securities to the Federal Reserve System, then the securities are being purchased by the noncentral bank, and the impact on the growth of the money supply is de minimis.

From the point of view of monetary policy, the presence of deficits, particularly standardized deficits, make it much more difficult for us to operate monetary policy. It is a very expansive fiscal policy. If you continue to have major inflationary pressures in the economy, the offsetting side of that, then, has to be a continuation of a more restrictive monetary policy than you would have had if you could have gotten the budget back closer to balance.

DEFICIT WOULD HAVE UPWARD PRESSURE ON INFLATION

Senator **Quayle**. Basically, under economic recovery, we are still looking at a fairly large deficit figure, and I gather that under the first response, that deficit would have an upward pressure on inflation.

Ms. **Teeters**. Basically, if you are running a deficit at full employment, whatever your definition of full employment is, it means that the Federal Government is reaching for more resources than it is taking away from the general public in taxes.

I would add one caveat to this. You really want to look not only at the Federal Government, but at the Federal, State, and local governments combined, because traditionally in the past, the States have run surpluses. You really want to look at the overall deficit or surplus of the total Government sector.

Do not forget that we give the State and local governments $90 billion a year. $90 billion of the Federal deficit goes to the State and local governments, and to the extent that they run surpluses, you have cut down then on the Federal deficit, looking at it as a total.

But as we look out to 1984 and 1985, with the reduction in the grants-in-aid, the large tax cut, the increase in defense, and whatever definition of full employment that you want, we see the government sector in substantial deficit.

Senator **Quayle**. Would that substantial deficit be the aggregate, also, of State, local, and Federal?

Ms. **Teeters**. Putting it altogether, you still have a deficit.

Senator **Quayle**. That substantial deficit, from an economic point of view, is unhealthy.

Ms. **Teeters**. It is a very expansive fiscal policy. In an economy which has continuing inflationary tendencies, if you have an expansionary fiscal policy, you get rapid rates of real growth; things are still unstable on the price side. If the rates of real growth are too rapid, you could create inflationary pressures again.

If it is too expansionary on the fiscal side, you have the presumption that the monetary policy would attempt to restrict the expansionary policy in order to maintain pressures on inflation.

Senator **Quayle**. Thank you very much.

Senator **Gorton**. Thank you.

Our final witness will be the Assistant Comptroller General of the United States, Harry S. Havens.

Mr. Havens?

STATEMENT OF HARRY S. HAVENS, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE

Mr. **Havens**. Thank you, Mr. Chairman. I have a formal statement, but with your permission, I would propose to enter the statement in the record and only summarize a few highlights of my paper.

Senator **Gorton**. Thank you.

We will have that included in the record in full, yes.

Mr. **Havens**. Thank you.

The main points I would wish to make at this point are that we agree with the earlier witnesses that the rapid growth of Federal credit programs makes it increasingly important to bring these programs under the discipline of the budget process.

Over the years, GAO has done a fair amount of work in the area of credit programs dealing with specific issues. In addition, we have long supported the view that the Congress should establish a credit budget as part of its annual budget process.

FURTHER PROBLEMS THAT WARRANT ATTENTION

In addition to our previous work, we are now looking at two further problems which we think warrant attention. First is the inadequate data about credit programs which is published in the budget. It is difficult for the Congress or anyone else to set systematic priorities among programs without consistent, reliable, and readily available data on such basic matters as program costs.

A second problem is the wide diversity of interest rates in Federal credit programs. This diversity seems in at least some cases to reflect little more than historical accident. The tendency of program interest rates to lag behind Treasury borrowing costs, particularly if the rate is set in law, produces substantial subsidies, some of which we believe were never intended.

We suggest, therefore, that the Congress adopt a single formula for setting interest rates in relation to Treasury borrowing costs.

Finally, the GAO recommends that the Congress continue its efforts to find ways of allocating resources among programs, including credit programs, in a fashion that promotes both equity and efficiency. We would be pleased to work with you in your efforts to achieve those objectives.

That summarizes my main points. I would be happy to respond to any questions you may have, sir.

Senator GORTON. Thank you, Mr. Havens.

PREPARED STATEMENT OF HARRY S. HAVENS, ASSISTANT COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Task Force:

We are pleased to be here today to discuss our views on strengthening budget controls over Federal credit assistance programs.

BACKGROUND

Increased interest has been shown in recent years for measuring the impact and controlling the amount of Federal participation in the credit market. In part, this is a reaction to the rapid rise in the use of credit for public policy purposes. In addition, however, there have also been increasing subsidies available to borrowers because of the widening gap between Government loan terms and commercial loan terms. New net Federal lending increased nearly threefold since 1972, reaching $80.7 billion in 1980.

These figures represent net loan transactions, and do not reflect the full magnitude of the loan activities. Most of the growth has been in loans made by off-budget agencies and by Government-sponsored enterprises whose outlays do not get counted in the budget totals. Since 1970 the total loan amounts outstanding have risen by about $438 billion to $614 billion in 1980, an increase of about 250 percent. The amount of the subsidy element also grew during this period as legislated interest rates lagged behind rising Federal borrowing rates. Given this background, combined with recent economic trends and the current pressure for reduced Federal spending, we believe the Congress should continue to strengthen its procedures for controlling Federal credit programs through the budget.

Until recently, the Congress and the Executive Branch have exercised only limited control over credit programs. Many credit activities do not go through the normal budget process, and either are not included in budget totals or are reflected only as the net of new loans minus repayment of old loans. Other costs, such as the subsidy element, are also frequently understated in the budget documents.

Credit programs need to be evaluated and to compete for budgetary resources in the same manner as other assistance programs. Where program costs are not fully disclosed during the regular budget process it is difficult to make sound judgments among these competing programs.

SPECIFIC CONCERNS GAO HAS ADDRESSED IN THE PAST

In recent years, GAO has addressed a variety of issues affecting Federal credit programs, and has made a number of recommendations. For example,

- --We recommended that the Federal Financing Bank (FFB) be included in the budget, rather than making large volumes of what are, in fact, direct loans outside the budget.
- --We recommended that the outlays of revolving funds be reported on a gross basis, rather than continuing to understate loan activities by netting new loans against repayments.
- --We recommended that budget authority for direct loans be based on the authorized loan level (the amount of new loans to be funded), rather than on the amount of new Treasury borrowing required to fund those loans.
- --We recommended that certificates of beneficial ownership be treated as agency borrowing, rather than as the sale of an asset.
- --Finally, we have long held that systematic congressional review, oversight and decision making through the budget process is as important for credit programs as for any other sort of program. For this reason we have urged the Congress to act on a "credit budget" in its annual budget process. We are pleased

to note the significant steps taken by the Congress along these lines over the last few years.

CURRENT GAO WORK

Currently GAO is studying the loan terms in Government credit programs with a view to identifying the different types of loan program costs. We are also looking at the need for standards and classifications for treating various aspects of credit activities. One purpose would be to assure reasonable consistency in the data available to decision makers.

Little information is available to help identify Government credit costs. Although some recent improvements have been made, information systems maintained by OMB, Treasury, and CBO do not adequately identify credit costs, despite the fact that agencies maintain considerable data at least on a program by program basis.

The credit information system presently contains the annual gross amount of direct loan obligations, loan guarantee commitments and outstanding credit blances. This information is valuable, but it is neither complete nor accurate. Recently, the administration has emphasized the need to improve estimates. For example, fiscal year 1981 estimates were recently revised to avoid double counting $16.6 billion in FFB loan assets and to correct technical errors of $5.1 billion in TVA and biomass energy development programs. Many examples have been found which indicate continuing problems with current data. It appears that many of these problems occur because agencies do not place a high enough priority on credit information to develop reliable estimates.

We believe that if the Congress established a formal control mechanism, a higher priority would be placed on developing adequate estimates.

Several other preliminary observations are summarized below.

--Interest rates for credit programs are not standardized and can vary considerably, from no interest charge to Treasury borrowing rates (now about 15 percent). The interest rates for direct loans or guarantees are basically set in one of the following ways:

--rates are fixed in legislation;

--rates are pegged to a fluctuating rate, usually some indicator of Treasury borrowing costs; or

--rates are negotiated between borrower, lender and the Government.

We have found that most rates that are set in law are very low for today's condition. In some cases, it appears that the original intent of the program was to make credit available (at cost) to certain groups who could not otherwise obtain loans, rather than to provide interest subsidies. However, as Treasury's borrowing costs rose, many of the interest rates remained unchanged. Thus, the borrowers have received an increasingly substantial subsidy.

Where the intent is only to make credit available and not to provide an interest subsidy, the Congress should base the rates on Treasury borrowing costs, rather than fixing the rate in law. In a period of unusually high or rising interest rates, this approach could yield substantial savings. It would also avoid the creation of subsidies which were not intended and may not be warranted. In 1980 and 1981 some efforts were made to correct the low interest rates in a few programs. For example, loans to parents of college students were raised from 9 percent to 14 percent. However, the rate continues to be fixed in legislation.

Interest rates pegged to a Treasury rate also vary somewhat because there are many methods of computing the Treasury rate. It seems doubtful that the pattern of rates reflects a conscious strategy in which a particular rate is chosen because it better represents the cost of funds to the Government or the cost of equivalent private borrowing.

We suggest that the Congress consider establishing a formula for setting a basic interest rate that would approximate the cost of Treasury borrowing. This would avoid unintended differences in programs. Establishing a standard formula for setting the basic interest rate would allow the Congress to establish the subsidy with confidence that it would remain unchanged over time.

--There are several information problems we are addressing. For example, appropriation account data in the budget does not disclose the full Government costs of the subsidies provided to borrowers. In the case of a few guaranteed programs (e.g., student loan insurance) there is a line item showing subsidy costs as required by legislation. For most programs the direct interest subsidy costs are not identified separately for loans or guarantees and only appear in budget totals to the extent that program expenditures are greater than income. Similarly the estimated costs of delinquent and defaulted loans and administrative costs are not not routinely and consistently reported in the budget.

ACTIONS THAT NEED TO BE TAKEN

Efforts have been made to strengthen controls over credit activities in the past several years. Legislation has been proposed that would go a long way toward establishing such controls. In the 1981 and 1982 budgets, the Executive Branch proposed a credit control system for reviewing and regulating annual credit activity on a program by program basis. The system was intended to work through appropriations limitations on annual gross direct loan obligations and guaranteed loan commitments. So far, the approach has been implemented only on a piecemeal basis.

In another effort to bring credit programs within the discipline of the budget process, the Concurrent Resolution on the budget for fiscal years 1981 and 1982 contained recommendations of targets on aggregate totals. The 1982 resolution also contained targets on functional totals although these are not binding ceilings. Legislation has been introduced to amend the 1974 Budget Act to establish procedures for setting targets and ceilings within the congressional budget process for direct and guaranteed loans.

We support the objectives underlying each of these efforts. We continue to believe it to be important that Congress find ways of allocating resources among programs--including credit assistance programs--in a fashion that promotes both efficiency and equity. We would be pleased to work with you in your efforts to achieve these objectives.

That completes my prepared statement. I would be happy to respond to any questions.

Senator GORTON. As is usually the case with GAO which you represent, your statement is short, succinct, to the point, and very, very helpful to us in this process.

Mr. HAVENS. Thank you.

NEGATIVE BUDGET AUTHORITY AND OUTLAYS

Senator GORTON. We appreciate very much that assistance. Much of the confusion surrounding direct loan programs arises from the fact that loan repayments are scored as negative budget authority and outlays. Can you explain briefly the reasoning behind this accounting method?

Mr. HAVENS. Well, it is an approach which we have recommended be changed on a couple of occasions. It originally derives from the notion that the credit programs being operated by the Government are of a corporate entity variety, and that what the Government is doing is funding a basic corpus of the entity and that what the entity then does with that money is its own business, and the only thing the Government should be interested in is net additions to the corpus of the entity making the loans.

I think that is, in many cases, a fiction. I think the Government has a proper interest in the totality of the activity of the revolving funds, which are particularly what is affected here, and therefore we have recommended that the budget treat the outlays and revenues, or the revolving funds making these loans, on a gross basis rather than a net basis. We think that would be a much more accurate representation of the Government's activities.

ESTABLISH COMMISSION TO REEXAMINE BUDGET PROCESS

Senator GORTON. Dr. Rivlin and Governor Teeters recommended establishment of a commission to reexamine the budget process. Do you have any comments on that recommendation? Do you join in it?

Mr. HAVENS. We concur with that recommendation; it is one that we have made on several occasions over the past 2 or 3 years. We believe that it having been now almost 15 years since the President's Commission on Budget Concepts in 1967, there are a number of problems which would warrant the attention of a high-level commission in the budget area.

We issued a report about 8 months ago, or something of that time period, in which we summarized a number of issues that we felt should be brought to the attention of such a commission and which we believe the commission should address. A number of other issues, we believe, are ready for addressing by the Congress at this point, some of which are in the credit area, such as treatment of the Federal Financing Bank and a few other odds and ends like that.

But we do believe that it would be appropriate to have a commission and to put it to work as soon as possible.

Senator GORTON. The widespread nature of those recommendations and the varied sources from which they come and the, at least, partial breakdown of the budget process here in the Congress and the dissatisfaction of many Members with the present system all seem to point in the same direction, do they not?

Mr. **Havens**. They do indeed, and we are very pleased, candidly, with the consensus which seems to be arising on the need to take another very hard and deep look at the budget process.

Senator **Gorton**. It seems to me that we are on the threshold of just such reforms 'and I should like to thank GAO for its participation to this point, and state that its participation and suggestions as we go into this process are going to be most important to us.

I appreciate your appearing, Mr. Havens.

Mr. **Havens**. We will be happy to assist in any way, and thank you for the opportunity to appear.

Senator **Gorton**. Thank you.

That adjourns the meeting.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

OVERVIEW OF FEDERAL CREDIT

WEDNESDAY, FEBRUARY 10, 1982

U.S. SENATE,
TEMPORARY TASK FORCE ON FEDERAL CREDIT,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The Task Force on Federal Credit met at 2:06 p.m., in room 6202, Dirksen Senate Office Building, Hon. Slade Gorton presiding.

Present: Senators Grassley, Kasten, Quayle, Gorton, Sasser, and Metzenbaum.

Staff present: Stephen Bell, staff director; David Nummy, special assistant to the staff director; Lizabeth Tankersley, minority staff director; and Ann Hadley, analyst for credit budget.

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. I am pleased today to welcome our witnesses to this hearing of the Task Force on Federal Credit of the Senate Budget Committee. The Budget Committee is required by the Budget Act to study and report to Congress methods to improve the congressional budget process. This hearing today is the second of a series in which the task force will examine the activities conducted by the Federal Government which provide credit assistance and the relationship of those activities to the budget process. The findings of this task force will result in recommendations that can be utilized by the full committee.

The Federal Government makes substantial commitments in many areas of the economy. Unfortunately, a significant portion of those commitments, such as tax expenditures, entitlement programs, and credit assistance, are excluded from annual consideration by Congress. It is the last of these items—credit assistance—which is of importance to this task force and the object of discussion of our hearings.

CREDIT ASSISTANCE DESERVES CLOSE ATTENTION

Although the details of Federal credit programs are not well known, the sheer size of total Federal activity deserves our closest attention. The most recent projections indicate that total Federal participation in U.S. credit markets this year will be over $200 billion and will absorb over 40 percent of the total amount of credit available. There is an impending disaster facing many of our businesses whose lifeblood is a stable and affordable supply of credit. If our actions in Congress are determining the interest rates and availability of credit for the private unassisted borrower, it is imperative that we take action only with the full knowledge of what we do and the effect our actions have on the capital markets.

I am concerned by testimony of previous witnesses that indicate our presence in the financial markets is having significant impact on interest rates and the allocation of our Nation's scarce capital resources. Our witnesses today have an intimate knowledge of the mechanics of the financial markets due to the nature of their profession or through the extensive research they have conducted. The perspective they bring to our proceedings is invaluable.

I am also concerned by the current treatment of these activities in the budget. While all direct loan programs except REA are on budget, the use of the Federal Financing Bank to place many of the outlays outside the budget and the revolving fund technique of counting loan repayments as negative outlays and budget authority has effectively excluded all funds used for direct lending from the budget totals. Of the $53 million on loan disbursements projected for fiscal year 1983, only $2 billion or 3 percent will show up as net outlays in the unified budget. In addition, none of the projected $87 billion in guaranteed loans can be found in the budget since they are excluded by law. The failure to account for the programs that have such a significant impact on our economy is a loss of fiscal control. The failure leaves the budget process deficient.

The full Senate Budget Committee will shortly analyze the Budget Act. Hopefully that discussion will lead to an improved budget process that is better able to control the Federal Government's fiscal operations. The changes in the process must include the means to account for and control off-budget expenditures, including credit assistance.

I look forward to hearing the thoughts and insights of our witnesses here today. We would prefer that opening statements be summarized in 10 minutes. Prepared statements will be made part of the record.

We are especially honored to have Dr. Alan Greenspan as our leadoff witness, and without further introduction, I will turn this meeting over to him.

Dr. Greenspan, I hope that several other members of the committee will be here promptly, but I do think that we should proceed.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN AND PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Dr. **Greenspan**. Thank you very much, Mr. Chairman.

In a period when on-budget deficits are threatening to become inordinately large, there is a danger that we may be lulled into moving some of the on-budget activities into off-budget and other Federal credit sponsored activities. The credit markets do not accept the subtle distinctions which allow certain activities to be recorded in the budget deficit and other activities to be excluded.

FEDERAL CREDIT DEMANDS STAGNATE ECONOMY

The basic reasons why the budget deficits are dangerous to our economic well-being is that they either prevent private productive investment or induce the Federal Reserve, concerned with the issue of rising interest rates, to overly expand commerical bank reserves, causing excessive money supply growth and heightening inflation. This ultimately also undercuts private capital investment.

In short, excessive Federal credit demands have been a major force behind the stagnation of the American economy for the past decade.

It is true that not all forms of credit, sponsored directly or indirectly by the Federal Government, have the same impact upon the economy. However, almost all of them differ in a fundamental way from private credit. Unlike almost all other forms of credit demand, including that of State and local governments, the demand by Federal agencies is insensitive to interest rates. That is, the demand for funds is wholly inelastic with respect to the rate of interest. The Federal Government will borrow to meet its needs, independent of what it has to pay in interest.

TREASURY WILL PAY INTEREST RATE REQUIRED TO OBTAIN FUNDS

This is clearly the case with on-budget financing. Whatever the Treasury requires to meet its expenditures obligations, it will borrow in the market, paying the interest rate required to obtain the funds. It will sell bills, bonds, or notes at any price necessary. Private borrowers, on the other hand, are generally sensitive to interest rates. At one extreme is the large block of mortgage borrowing for new homes. It is fairly obvious, as recent evidence has indicated, that as mortgage interest rates rise, the ability to borrow declines markedly. Business borrowing is somewhat less sensitive but, nonetheless, when rates have gone up, there has been a pronounced contraction in commitments which require external financing. Even State and local governments will delay capital projects so as to avoid the necessity of entering the bond market to obtain funds when interest rates are too high.

It is this phenomenon which explains the so-called process of crowding out.

A limited amount of savings is generated in the private sector during any one period of time. Hence, if aggregate demand on that pool of savings exceeds the amount available, those borrowers who are willing to pay the highest interest rates will clearly outbid, that is crowd out, those who are willing to pay the rising bid. This is why the Federal Government is always at the front of the queue, so to speak, and takes what it wants. What is left over is allocated by market to those remaining who are able to pay for the credit.

When private businesses cannot obtain funds in the capital markets, they generally go to their commercial bankers. In an endeavor to satisfy the customers' needs, the banks bid in the Federal funds market for reserves with which to support lending to the previously crowded out borrowers. The consequent bidding up of interest rates on Federal funds confronts the Federal Reserve with the politically sensitive problem of either (1) not supplying reserves to accommodate the demands of the private sectors crowded out from direct borrowing in the capital markets, thereby allowing short-term money market rates to rise sharply higher or, (2) as it has too often been inclined to do, partially accommodating the excess demand for funds on the commercial banks. The latter process requires the purchase of, say, Treasury bills and the supplying of reserves to the commercial banking system. It expands the monetary base and eventually the larger money supply leads to a higher rate of inflation which eventually pushes up interest rates anyway.

If the Fed does not accommodate the demand at all, then obviously we do not have excess reserve balance creation. We do not have inflation, but we do have a level of interest rates which effectively prevents private borrowers from financing their commitments. So, in this sense, one can see that there is no way to neutralize excess Federal credit requirements.

FEDERAL GOVERNMENT PREEMPTING REAL ASSETS FROM PRIVATE SECTOR

Money and credit are merely claims to physical assets, goods, and services. Behind the movement of funds and interest rates are quantities and prices of physical assets. What we are observing, in the process of crowding out, is the Federal Government preempting real assets from the private sector.

It is through its budget and taxing power that the Federal Government endeavors to effect the flow of goods and services throughout the economy. This is done not only through the regular Federal budget process with which we are all familiar, but also through the extraordinary proliferation of so-called off-budget activities, federally sponsored credit agencies and a wide variety of credit guarantees and regulations whose effects are similar to on-budget activities. While some forms of indirect Federal borrowing differ in their impact from direct borrowing, to a greater or lesser extent, they, too, preempt credit and resources from the financial and income producing markets, and create the same effects as on-budget borrowing and the creation of direct Federal debt.

There are some differences, however, and it is worthwhile outlining them and endeavoring to get some judgments as to the aggregate quantities involved and their overall impact. Clearly, Federal Financing Bank borrowing is indistinguishable from other direct Treasury borrowing. The Federal National Mortgage Association, the Federal Home Loan Banks, and other federally sponsored credit agencies conduct types of operations which give them only a very modest degree of flexibility in borrowing relative to interest rate levels. For example, the heavy borrowing of the Federal Home Loan Banks in the open market in the last year or two reflects the large advances which the banks have given their member savings and loan associations.

Federal credit guarantees are clearly a somewhat different type of instrument. These consist mainly, though not exclusively, of mortgage related guarantees. It is difficult to measure the precise impact on the credit markets of these various forms of guarantees, but clearly $1 of guarantee has significantly less overall crowding out propensity than $1 of direct Treasury borrowing.

Finally, there is another type of Federal credit preemption—the capital expenditures mandated to meet environmental and safety regulations. There is little difference so far as financial markets are concerned whether (1) the Federal Government subsidizes an electric utility to purchase a scrubber and then sells Treasury issues in the capital market, or (2) the Federal Government guarantees the utility's issuance of its own securities to finance the scrubber, or (3) the utility sells its own unguaranteed securities to finance it. There is some question, of course, as to whether environmental regulations add dollar for dollar to the Nation's capital investment or, as seems a bit more likely, whether it is financed in part by a reduction in other capital investment. Thus, a dollar of mandated outlays and borrowings probably impacts the financial markets, dollar for dollar, less than direct Treasury financing.

It is difficult to find a wholly adequate measure to determine the financial impact of the overall Federal preemption of credit. However, "Special Analysis F" of the Federal budget, which endeavors to relate Federal borrowing from the public, by sponsored credit agencies and guarantees as a percent of net funds raised, certainly captures the major rise in Federal borrowing, direct and indirect, in recent years.

RELATIONSHIP BETWEEN DEFICIT, OFF-BUDGET BORROWING, AND INFLATION

As I think you pointed out Mr. Chairman, there is a very significant rise in the proportion of total credit preemption by the Federal Government as measured by this measure or, for that matter, any other measure. Those who argue that there is no direct relationship between deficit and off-budget borrowing and inflation have not been looking very closely. The relationship is not an annual one, nor is it one which occurs, over a 2-year period. But if you allow enough time to elapse, a full cycle, there is just no question that the relationship traces our inflationary processes.

Constructive limits on aggregate Federal preemption of credit is long overdue. I do not underestimate the difficulty of the task involved, but in the current environment, where on-budget deficits are threatening to get out of hand, there will surely be a rise in endeavors to promote Federal causes in other ways and to finance them by means other than on-budget programs. Unless adequate restraint is imposed on these other avenues of Federal credit and resource preemption, endeavors to reduce the on-budget deficits, even if successful, will turn out to be a paper victory.

Thank you.

Senator GORTON. Dr. Greenspan, thank you.

Unfortunately, as you know from your experience here, we are liable in the afternoons to get interrupted. We have a rollcall going on right now. Senator Metzenbaum has gone to vote and will be back shortly and does have some questions for you. Senator Kasten has arrived. We will take a few minutes prior to voting to ask a few questions.

I did have one question which I think is answered by your formal statement. The task force started this project because of the tremendous focus which has been placed on the on-budget deficit and the effects it has on the economy compared with the almost total inattention to the off-budget deficit and the impact of Federal loan guarantees. My question was, how do these differ from one another, and if I summarize correctly, your answer is that an on-budget deficit and an off-budget deficit have directly the same impact on the markets but that forms of Federal guarantees, while they do impact the credit market, are less than a direct expenditure on a dollar to dollar basis.

Dr. GREENSPAN. That is correct, Senator.

LARGE DEFICITS ECONOMICALLY DANGEROUS

Senator GORTON. I guess what I would like to go on from there is that at least by one measure the combination of those three items project out to a $159 billion or so deficit for this year which is certainly at an unprecedented high level. I would simply like your openended comments, if you wish to make them, on whether or not the American economy can endure these levels of credit consumption by whatever title it comes on the part of the Federal Government.

Dr. GREENSPAN. Mr. Chairman, it is difficult to make definitive judgment on whether one can absorb any specific set of numbers. But one thing we know with a reasonable degree of surety, is that the risk involved in allowing deficits to be created of the size which we are in the process of discussing is just too large.

In other words, if we put that type of pressure on the financial system, it is conceivable we may luck out. But what we are dealing with is the whole American economy. I do not think that we can even remotely afford to take the types of risk that those outsized deficits imply. I would suggest that we make every endeavor that is feasible to find a way of bringing the path of deficits down.

LONG-TERM INTEREST RATES

Senator GORTON. You are quoted in the Wall Street Journal today as expecting only a very small decline in long-term interest rates over the next 2 years. Can you expand on that by telling me what you feel the relative impact on interest rates of loan guarantees and the deficit amounts that we now anticipate will occur. What would you expect to be the change if the Congress were to take a course of action sharply different from that of the President, one which promised markedly lower deficits in 1983, and the absence of any deficits at all by roughly 1985?

Dr. GREENSPAN. Well, first, Mr. Chairman, we have to define how the deficits affect long-term interest rates in a specific way and the channel, I think, is relatively straightforward. Remember that a substantial part—in fact, at this particular stage, by far the largest part of the level of nominal long-term Treasury yields is an expected inflation rate; that is, it is the average expected annual reduction in the purchasing power of the dollar through the maturity of the debt instrument involved. The so-called real rate of return on the basis of several centuries of historical experience, is roughly only 3 percent and does not vary very much from that.

We estimate that the implied inflation forecast that is embodied in the current level of interest rates (14 percent) is approximately 10 percent probably for the next 10 or 15 years. The remaining 1 percent is attributable to risk aversion. It is a tough guess to make, but I think the behavior of the market in the last several months suggests that they are, in effect, discounting the level of long-term budgets which are consistent with something in the area of $120 to $130 billion in on-budget deficits for fiscal 1984 and fiscal 1985, and that that is translated into a rate of growth in money supply which I believe approximates the 10 percent average annual rate of increase expected in the price level.

So the bottom line, as I see it, is that the markets have already discounted, not the President's budget deficits, but much higher ones. If the President's budget deficit prevailed, I think we would get a very significant decline in interest rates, and even his deficit numbers are large by historical experience. If we got something very substantially below that and those deficits appeared to be moving down permanently, then we could look, with some lag, to a restoration of the types of interest rates we had 10 years ago.

Senator GORTON. Thank you.

We will have to recess for just a moment, but Senator Metzenbaum, when he comes back, will ask some additional questions, and Senator Kasten will, of course, have some questions.

[Short recess.]

OFF-BUDGET ITEMS OUGHT TO BE ON-BUDGET

Senator METZENBAUM. Greetings. Nice to see you again. We will just reconvene the hearing and go forward.

I came in late for your statement and had to leave early for the rollcall. But am I correct in my understanding that the thrust of your comments—or I am not even sure if this is a correct statement—do you feel that all of the off-budget items ought to be on-budget?

Dr. GREENSPAN. I would say, Senator, that the vast proportion of them should be. If they are not, they should be sufficiently monitored and reported upon so that the budget process itself is capable of coordinating them and at least creating as a minimum the lack of opportunity to effectively move what would ordinarily be on-budget type financing into off-budget financing. I would expect if it came to an all or nothing issue, I would like to see all of it on-budget.

Senator METZENBAUM. On-budget?

Dr. GREENSPAN. On-budget. Although I suspect it would probably create a number of technical accounting problems which might not be desirable.

In other words, for example, the question——

Senator METZENBAUM. Pull that a little closer to you.

Dr. GREENSPAN. There are a number of credit guarantees which are indistinguishable from direct Federal borrowing. I can conceive of situations in which one might not want them on-budget. But the arguments are so strong in the other direction that if we err, I would hope that we err by putting too much on-budget rather than too little.

DEFAULTS

Senator METZENBAUM. What about the matter of default? It has always been disturbing to this Senator that our Government has no uniform procedure to monitor defaults, and that some agencies do not even keep a record of when a loan is in default and when it is not.

Do you have any thought or suggestions on that subject?

Dr. **Greenspan**. Well, I think what has happened, Senator, is that we have fuzzed the relationship between loans and grants. I would suspect that there may be some agencies who are under the misapprehension that even though it stipulates in the statute that what they are doing is making loans, they behave as though they are grants. It may be an issue as simple as a misunderstanding because it does not strike me as a conceivable managerial operation that one can be lending money and have inadequate records on whether loans have been paid off, defaulted upon, or are in arrears.

Senator **Metzenbaum**. But it is the fact that it is what is happening in our Government?

Dr. **Greenspan**. That is my understanding, sir.

Senator **Metzenbaum**. When you were part of Government, was the same problem—was that same problem stamped? Did it exist at that time as well? Not so many years ago, only to a lesser degree?

Dr. **Greenspan**. I would say so.

IMPACT OF DEFICITS ON INTEREST RATES

Senator **Metzenbaum**. Do you think that—what is your opinion as to the impact upon high interest rates of Federal deficits?

Dr. **Greenspan**. I think that they are the major cause and have been the major cause of the high interest rates over the last several years. Since the extraordinarily rise in long-term interest rates which began in the summer of 1979 and continued through the remainder of that year into the early months of 1980, we have had a financial market which largely reflects the impact of long-term inflation expectations, and they in turn are affecting long-term interest rates. I am of the opinion that the major force pushing short-term interest rates high is the attempt on the part of borrowers to eschew long-term borrowing and to concentrate borrowing short term.

Senator **Metzenbaum**. Waiting for the rates to go up?

Dr. **Greenspan**. To come down rather.

Senator **Metzenbaum**. Waiting for the rates to come down?

Dr. **Greenspan**. Long-term rates to come down. A business organization which ordinarily would place, say, 75 percent of its borrowing short term and 25 percent long term would probably go to 85/15 temporarily, awaiting long term interest rates coming down. What that does, in effect, is to create an excessive growth in short-term credit demand and acceleration in the rise of outstanding business short-term debts to total debt and thereby put considerable pressure on short-term interest rates as demand spills over from the long end of the market.

So, in summary, I would say that it is the long-term inflation expectations which have been the major force moving interest rates in this country in the last 2 years, both short term and long term.

DECLINE IN LONG-TERM INTEREST RATES ANTICIPATED

Senator **Metzenbaum**. With the substantial deficits that are anticipated, and with the fact that even those—by the administration—the fact that those deficits are actually substantially lower than the figures that you and other economists were reported as projecting as of today's Wall Street Journal, I am somewhat at a loss to understand why you would sort of intimate by your answer that the long-term rates will be coming down in the future since it seems that the deficit is going to continue to grow.

Dr. GREENSPAN. Basically, Senator, because I think that the markets have adjusted, that is discounted a level of Federal deficits which are in the area of $120 billion for 1984 and 1985, and rising thereafter. In that sense, the dramatic runup in interest rates during the recession was largely a reflection of the change in the long-term budget deficit outlook. It is obviously always difficult to judge, but the rise in the long-term interest rates, from early December—the time when the leak of what the deficit could be in the outyears—to early January, was largely ascribable to a major alteration in the financial market's view of the expected long-term deficits.

What I am saying is that I think they probably have overdiscounted, they have overdone it.

Senator METZENBAUM. So if I understand you correctly, you are saying that you anticipate long-term rates to be coming down?

Dr. GREENSPAN. Modestly.

Senator METZENBAUM. At what point do you think that will occur?

Dr. GREENSPAN. When it becomes apparent that the most adverse set of long-term budget forecasts start to be proved wrong.

In other words, if it became clear that these longer term deficits—I am talking of $150, $160 billion on-budget levels—were clearly unacceptable by the Congress and that actions were being taken to bring them down, I think the markets would react rather abruptly.

Senator METZENBAUM. So then if I understand you correctly, what you are saying is that absent the Congress taking the bit in its teeth and bringing down the budget deficits, both as anticipated by the administration and even further with respect to the greater deficits, that private economists and CBO are anticipating, absent action to do something about that, that the rates will not come down, they will continue upward?

Dr. GREENSPAN. I am saying absent anything which changes the current service's deficit.

Senator METZENBAUM. Current what?

Dr. GREENSPAN. Current service's deficit, meaning the deficit which would prevail were no action of any type, taken either on the revenue or on the outlay side. Then the answer is yes.

I would, however, point out that if the administration's trend of deficits actually prevailed, we would get a very significant decline in interest rates largely because I think that the markets have already discounted a level of deficits far in excess of that presented by the administration last week.

Senator METZENBAUM. But as one of our Nation's most prominent economists said today, "Nobody believed the administration's projections as the most likely forecast."

That is what you said, is it not?

Dr. GREENSPAN. Yes, sir. That is the reason why, at this particular point the markets have discounted a level of deficits which were significantly above the administration and why I therefor concluded that if the administration's deficits did prevail, interest rates would come down.

HOUSING AND AUTO SALES AFFECTED BY LONG-TERM RATES

Senator **Metzenbaum**. All right.

Now, the affected different segments of the economy, if these long-term interest rates stay high on houses, on the auto industry, business, State and local governments, do you care to comment on either one or all of them?

Dr. **Greenspan**. There is no question, Senator, that at these levels of interest rates the economy is in very difficult shape. The mortgage market is such that if we can eke out anything over 1 million housing starts, we are doing well and, needless to say, that is an extremely low level of housing starts. The levels of long-term interest rates is probably more important to the weakness in automobile sales and light truck sales than is short-term rates.

The reason is that the rates of interest on the purchase of cars, on the installment basis, has not been a major problem. But what has been is the failure of the turnover of existing homes. In the past these have created very substantial realized capital gains. These in turn have been a major source of financing for passenger cars in this country. And as a consequence, it is not an accident that auto sales and housing starts have moved in tandem, both up and down for many years. They are both reflecting the same forms of financing.

So when we choke off the mortgage market, we are also choking off a substantial amount of the downpayments on passenger car sales. Therefore, anything which keeps long-term interest rates up, anything which, for example, keeps mortgage rates at 16 or 17 percent, keeps the economy in a very suppressed mode.

LEVEL OF SHORT-TERM INTEREST RATES

Senator **Metzenbaum**. I think that you are one of those who are supportive of the Fed's position, tight money policy, am I correct in that?

Dr. **Greenspan**. Yes, I am. I am supportive of the Fed. I do not believe it is the Fed's tight money policy, that is creating the high level of short-term interest rates.

The level of short-term interest rates is largely a reflection of long-term rates which in turn are a reflection of the prospective budget deficits. I am not of the opinion that the Fed could significantly alter short-term rates for any protracted period of time even if they chose to do so.

Senator **Metzenbaum**. Even if they loosen up the money supply somewhat?

Dr. **Greenspan**. What they have control of, Senator, is the overnight Federal funds rate.

Senator **Metzenbaum**. Do they not also have control of the discount rate?

Dr. **Greenspan**. They do, but the discount rate is basically for Federal funds and the way that they control what they are doing is largely through the Federal funds market. They integrate it with the discount window. It is really the market for reserve balances of the commercial banking system. There is no question that the Fed can knock the Federal fund rate down, that is, the overnight borrowing rate for commercial banks to whatever level they choose. But there is an immediate consequence of that. Lowering the Federal funds rates requires an expansion of Federal Reserve balances. That in turn expands money supply. While that may keep the short-term rates down for awhile, long-term rates will then start moving higher. We may find, after a period of 2 or 3 months, that it is impossible for the Federal Reserve to hold those rates down, and we are back to where we were, perhaps almost surely worse off.

Senator METZENBAUM. I see several other committee members have come in. I would like to suggest for the record for their edification, including the chairman's, that I earlier asked you about your preference about putting all of the off-budget items on-budget, and I believe the response would—was that there would be some difficulties, but that in the main if it was all or nothing at all, you would be in favor of putting them all in. Is that a fair statement?

Dr. GREENSPAN. Yes, sir.

ADEQUATE ACCOUNTING OR COLLECTION OF DATA NEEDED

Senator METZENBAUM. And I think I also asked you about the question of putting into the budget some manner, a reflection or some accurate representation of the rates of default or the amounts of default, both with respect to on-budget and off-budget, and I am not certain that you answered that quite categorically. But I think by implication you indicated that it should be entered into the budget.

Dr. GREENSPAN. If it is not too much of a burden to collect such data, it would be helpful to know what those numbers are.

Senator METZENBAUM. It would be.

Dr. GREENSPAN. Yes, sir.

Senator METZENBAUM. Mr. Chairman, I have other questions but I see that both Senators Kasten and Sasser are here.

Senator GORTON. Senator Kasten.

Senator KASTEN. I would like to follow up on what Senator Metzenbaum was talking about.

It seems to me that accounting for all of these different items is a problem. Is it that we do not have adequate accounting and/or collection of this data. Do we have adequate information, but just not all in one place?

Dr. GREENSPAN. I think it varies, Senator.

On the issue of aggregate credit outstanding and the credit budget, so to speak, those data are available fully. That is part of the Federal budget process, and it is all available. I would say that some collateral information, such as what loans are in arrears, or which are technically in default, may not have explicit budget requirements. Obviously default would, but arrears would not.

So it is conceivable that those data may be spotty, and probably partially inaccurate.

Senator KASTEN. In 1975, when Bill Simon was at the Treasury and you were at the White House, there was an effort to set up a system for an accurate Federal financial statement. The idea was to present different Federal obligations. I think the Secretary of the Treasury testified once or twice before the Ways and Means Committee on this issue. There was even a bill introduced that addressed the whole process.

We never really got started, in part, because it seemed that we were not able to get the kind of data accurate that we wanted. Do you recall that? It was over 1 year, or 18 months, that that was discussed.

Dr. GREENSPAN. Yes, that is a problem that relates largely to the issue of creating a balance sheet for the Federal Government. There are a number of items which are not collected in the same place.

Federal Government receivables and payables, and a number of quasi-commercial type of transactions are not adequately recorded in a manner which would enable a Government-wide statistic to be appropriately evaluated.

I do think that the Treasury Department has been endeavoring to create and upgrade its estimate of what they call the balance sheet of the U.S. Government.

I am not, however, familiar at this stage with the technical advances that have been made from the primitive start on some of those estimates, 5 or 6 years ago.

CREATE CREDIT BUDGET

Senator KASTEN. But if you were to advise us in this task force to try to work out ways for both accurate and adequate accounting for this large group of expenditures, or guarantees, what would you recommend? What form would you recommend this accurate and adequate report take? We do not necessarily want a balance sheet of the U.S. Government, since the past experience we had was not so successful.

Dr. GREENSPAN. The activities which have been created in recent years, the creation of the so-called credit budget, is quite important. Many Federal activities can be carried out equally well, both on-budget and off-budget.

The political processes which constrain on-budget, have been well documented in recent days. But the ability to move off-budget, and seemingly have a blank check, is much too much of a potential problem when the pressure to reduce on-budget deficits is becoming very substantial.

In other words, there is a large possibility of a big leak in the budget being created, in which numbers of programs move from on-budget financing, to off-budget in order to change the level of the on-budget deficits without changing the actual programmatic structure itself.

Senator KASTEN. You made that point in the last paragraph of your statement as well. I think if there is anything that should underscore the importance, if you will, in the urgency of trying to get this credit budget in shape, it is exactly that.

We are seeing, for example, serious discussion of taking the Eximbank off-budget. There are other areas in which we are in the process of trying to make these switches. We are making the switches because of the political constraints and the binding nature of the budget process. We are going to see more of those.

Dr. **Greenspan**. There is no question, Senator, the easiest way to reduce outlays is to move it off-budget.

ESTABLISH BINDING CEILINGS

Senator **Kasten**. If we did work to a credit budget, and set ceilings, or goals, do you believe that we could establish binding authority, much as we have tried to have a binding process for the on-budget items?

Dr. **Greenspan**. That has the same difficulty as a binding process on entitlement programs, in which the initiation of the program or the credit is on the part of the recipients of the program. It is a larger problem in the credit area, because so much of the credit programs are generic in nature, with various entitlement qualifications defined. Obviously FHA, VA on the mortgage side, are examples as are a wide variety of other programs at other aqencies. Binding constraints will make it difficult, but it is essential that it be done. If it is not done, in a period when major advances are being made in bringing the published deficit under control, we may find that we have lost the inflation war through the back door.

Senator **Kasten**. You are saying it is essential that we establish binding ceilings, if that is at all possible?

Dr. **Greenspan**. Yes.

Senator **Kasten**. I agree. I think that the purpose of establishing the credit budget would be less than meaningful, if we did not at the same time make an attempt to establish these binding ceilings through some kind of a process.

All of us know that the budget process, with our ceilings and our goals, is somewhat wide, but at least it is a process.

Thank you, Mr. Chairman.

Senator **Gorton**. Senator Sasser?

Senator **Sasser**. Thank you, Mr. Chairman. I would like to include my prepared remarks in the record at this point.

PREPARED STATEMENT OF SENATOR SASSER

FEDERAL PARTICIPATION IN CREDIT MARKETS

Mr. Chairman, Federal credit is an area which deserves the Budget Committee's careful examination, particularly at a time when the administration is projecting the largest budget deficits in the history of the Nation—$91.5 billion in 1983, $82.9 billion in 1984, $71.9 billion in 1985. In a time of historically high real rates of interest—currently almost 8 percentage points over inflation where traditionally it has been 2-3 points—and negative economic growth, the availability of reasonably-priced credit becomes that much more crucial to those individuals and industries in the interest-sensitive sectors of the economy. The housing industry is in a depression and small business bankruptcies are at an all-time high. These are the economic realities confronting the American people today.

The provision of Federal credit assistance through direct loans and loan guarantees to achieve particular social and economic objectives has been widely recognized as a legitimate economic activity.

For example, the largest portion of credit assistance is provided to the housing sector. The first major loan guarantee program of the Federal Government was home mortgage insurance, begun during the Depression. Other sectors receiving help include agriculture, small business, and international trade. The bulk of this assistance has gone to correct market imperfections with respect to mortgage and small business credit. The absence of intermediate credit for small businesses has been the rationale for small business lending and guarantee operations.

In my home State of Tennessee, the ability of the Tennessee Valley Authority to borrow from the Federal Financing Bank at below-market interest rates has saved our taxpayers billions of dollars. The Rural Electrification Administration, over the years, has provided $297 million in insured loans to Tennessee electric cooperatives. The loss of these loans would have a serious adverse impact on power rates not only in Tennessee, but in rural areas across the country.

Over the years, the amount of net direct lending and net loans guaranteed has grown dramatically. According to the Congressional Budget Office, net loans guaranteed annually rose from $14 billion in 1977 to $32.4 billion in 1980, an increase of 131 percent. In the meantime, annual net direct lending rose from $11.6 billion to $24.2 billion in the same period, an increase of 108 percent.

Currently, the Congress does not have a set of procedures by which it can accurately evaluate the growth of Federal credit programs with respect to their economic efficiency. This is an area which this task force will explore carefully. I fully support these efforts.

Last year the Budget Committee set targets for credit and set annual limits for many credit programs in appropriations bills. This may have signaled a first step toward devising a permanent credit budget. Several proposals have been introduced which would make a permanent credit budget an integral part of the budget process. The purpose of these hearings will be to determine the need for such measures.

EQUITABLE PARTICIPATION FOR PRIVATE SECTOR

In conclusion, an over-arching question which must be addressed in our deliberation and recommendations must be how we can insure an equitable participation in the credit market by public agencies and the private sector in the face of the tight money and high interest rate policies espoused by the Federal Reserve Board.

Thank you.

ADMINISTRATION BELIEVES ECONOMIC ASSUMPTIONS ON WHICH BUDGET IS BASED

Senator **SASSER**. I was interested, Dr. Greenspan, to read in the Wall Street Journal this morning your statement about the budget. This may have come up prior to my arrival here.

But you say that, "I do not think the administration even believes their own budget."

Dr. **GREENSPAN**. I said something slightly different. I said that the administration's budget presupposes complete acceptance of all provisions recommended by the U.S. Congress.

Now, I do not believe the administration believes that is going to happen. I do not believe the Congress believes that is going to happen, and neither do I.

Senator **SASSER**. Do you think the administration believes the economic assumptions on which this budget is based?

Dr. **GREENSPAN**. Yes. Implicit in the program which the President has outlined is the assumption that all of his recommendations are enacted. And I would say if all of the President's programs are enacted, then the budget deficit will probably come down to where they are forecasting it; and if that is the case, then I think their economic assumptions are not particularly out of line.

My consulting firm forecasts are lower, but that is basically because we are assuming that only a moderate part of what the President has requested of you will, in fact, be granted.

EFFECT OF $40 BILLION VERSUS $100 BILLION DEFICIT ON INTEREST RATES

Senator **Sasser**. You indicated in your opening statement, which I unfortunately did not hear, and I apologize for not being here, but you said that excessive Federal credit demands have been a major force behind the stagnation of the American economy for the past decade.

We are now faced with the prospect of what, to me, is a shockingly large Federal deficit. Apparently you, I assume you accept the theory of crowding out. That is, when the Federal Government—and I think that is implicit in your statement—that when the Federal Government gets in the borrowing market, that it crowds out private investors, and interest rates go up. We are on the same wavelength, I would assume.

What would be the effect of a $40 billion or $50 billion deficit as opposed to a $100 billion deficit which is being widely predicted will occur?

Dr. **Greenspan**. I would say probably if you think in terms of——

Senator **Sasser**. What would be the effect on the interest rates?

Dr. **Greenspan**. Yes, I understand that, Senator.

First, let me make an explicit statement. The market, for say 1984, now assumes something close to a $120 billion deficit. Markets have assumed that, and discounted that, and that is what the current interest rate is reflecting.

If the markets change their view, that the actual deficit would be something in the area of $40 billion, and provided that you did not get there basically by huge counterproductive tax increases, you probably could take 3 or 4 percentage points off the long-term interest rate.

CONTINUE THIRD YEAR OF TAX CUT

Senator **Sasser**. Dr. Greenspan, if you were a U.S. Senator, and you were confronted with the question of whether to continue the third year of the tax cut, or to defer it, what would be your judgment on that?

Dr. **Greenspan**. I would continue it on the grounds that we had another problem a couple of years ago, which essentially was the issue of increased tax burden occurring as a consequence of inflation. I thought that at that time indexing the tax system was a highly desirable thing to do. The existing structure of tax rates that were passed in 1981 by this Congress, effectively does that.

If we start to unwind that legislation, we will unquestionably create increased revenues, but will bring back another problem which had been effectively solved by that legislation, namely, the removal of the automatic increase in the tax burden coming from inflation. So you would end up with two problems instead of one, although I will grant you that the first one would be in somewhat better shape than it is now.

In my view, on net balance, it is probably not a particularly good tradeoff.

Senator **Sasser**. You would prefer the larger budget deficit, and keep the tax cut in place?

Dr. **Greenspan**. That is correct. I would prefer neither, obviously, but if I were given that choice of unfavorable alternatives, I would lean to keeping the tax cut in place.

Senator **Sasser**. Unfortunately we politicians are faced with all unpleasant choices. There is not any pleasant alternative.

Thank you, Mr. Chairman.

Senator **Gorton**. Senator Grassley?

RELATIONSHIP BETWEEN MONETARY BASE, MONEY SUPPLY, AND INFLATION

Senator **Grassley**. In your testimony, you said:

> It expands the monetary base, and eventually the larger money supply leads to a higher rate of inflation, which eventually pushes up interest rates anyway.

I believe that, so I am not finding any fault with it. Is that a recent phenomena of the last few years, like 10 years or so, or has that always been the case?

Dr. **Greenspan**. Well, first of all, the relationship between the monetary base, the money supply and inflation, is a phenomenon going back as far as we have data. The relationship of expectations of long-term inflation——

Senator **Grassley**. And that is the point that I was——

Dr. **Greenspan**. Yes, that is new.

Senator, prior to 1979, as far back as one wishes to go in history, it was always the presumption, that the United States was, by its nature, resistant to inflation, and that inflation visited us only during wars, and their immediate aftermath, and that whenever we had an inflationary problem, it was always presumed to be short lived. No one ever projected high long-term inflation rates, and as a consequence, we never had large inflation premiums in long-term interest rates. That view changed dramatically in 1979, and it is something which is now confronting us. It is a major problem, and perhaps the most difficult issue that confronts the financial system.

Senator **Grassley**. Do you see a return to the historical relationship of interest and inflation, where interest might be two or three points above inflation, as it had been historically throughout our country? Do you see a return to that relationship in the near future?

Dr. **Greenspan**. Senator, as far as the long-term interest rate is concerned, I think we still have it. I do not think that that has ever changed, and I think that the rise in interest rates is wholly a reflection of increased inflation expectations, and not a rise in the real rate of interest.

It is true that we have, at this stage, an 8-percent short-term real rate of interest, meaning that the interest rate is running 8 percentage points above the current inflation rate. That is something that cannot prevail for a very long period of time.

PUT LID ON INTEREST RATES

Senator **Grassley**. I want to take advantage of your expertise, and ask you to think in terms of your—you being Senator Grassley, and I am a farmer or small business person, because I have had this question thrown at me many times, and I give an answer, but I am not sure that I always give the best answer.

The question obviously comes from a misunderstanding of how our economic system works, but that misunderstanding is out there, and we have to deal with it.

Why do you guys not, meaning Congressmen, put a lid on interest rates, or do something about interest rates? In other words, why do you not just say that the Federal Government is not going to pay more than 10 percent interest on any money it borrows, and then people in turn, you know, parenthetically feel that that is going to, you know, be all the higher interest rates are, and they think it is that simple.

Dr. **Greenspan**. I would say, in that event, Senator, you would end up with a balanced budget, because you would not be able to borrow any moneys. In fact, I would go further.

You probably would end up with a surplus, because the automatic rollover of the national debt would not be able to be refunded. As a consequence, you would have to employ tax receipts to pay off the debt, and would not be able to use them for expenditures. That might not be bad policy, when one thinks about it.

Senator **Grassley**. The only thing I would hope that you would come up with a different answer than I have given my constituents.

Dr. **Greenspan**. Senator, there is no way to finance——

FEDERAL GOVERNMENT WILLING TO PAY ANY INTEREST RATES

Senator **Grassley**. And now, if we could have just taught economics in a—understanding of economics in our school system, then I think our job here in Washington would be easier.

Lastly, can I have one more question? That is, in regard to the theory that I do not disagree with, but in crowding out, that the Federal Government is first in line to get money, and everybody else comes afterward, and everybody else pays a higher rate of interest.

But recently I have had people suggest to me, and so I am asking you, whether there is anything to it, that really maybe the Federal Government is not first in line. It may be in our economic system. There are major corporations, and major conglomerates, and major banks, or financial institutions, I should say, as opposed to banks, that are really there first in line, and that the Federal Government comes second, and then, of course, the farmer and the small business person is last in line, but that maybe the crowding out comes from larger forces in the free enterprise, in the private sector, before the Government comes in.

Dr. **Greenspan**. Well, I tried to address that in the formal statement here, Senator.

Senator **Grassley**. I am sorry, I did not see it.

Dr. **Greenspan**. It is a terribly important question.

Let me just rephrase what I said in the statement. What determines where you stand in line, or in the queue, is not your size, but your willingness to pay high interest rates. It is the very nature of the U.S. Treasury that it will pay whatever interest rate it has to in order to finance its expenditure obligations. There is no other entity in our economy which will do that. Even State and local governments will hold off capital projects if the interest rates are too high, and certainly commercial interests, whether they be large banks, large corporations, will back away when interest rates get too high.

So by exclusion, the Federal Government is first in line, but only because of its willingness to pay any interest rates, not because of its size.

Senator **Grassley**. Then there is no basis for any person feeling that anybody is in the queue ahead of the Federal Government, regardless of how large the economic interest is from the private sector?

Dr. **Greenspan**. That is correct, Senator.

Senator **Grassley**. Thank you.

Senator **Gorton**. Senator Quayle?

GAP BETWEEN INFLATION AND INTEREST RATES

Senator **Quayle**. I came back in the middle of your response and picked up on the last part, where you discussed an 8-percent gap between inflation and interest rates, if I am correct. I believe you went on to say that this is somewhat of a—I do not think you used the word phenomenon—but that it probably will not continue?

Dr. **Greenspan**. That is correct. Yes.

Senator **Quayle**. Do you really envision that at some juncture interest rates will get back to its historical past of being two to three points above inflation?

REAL RATE OF INTEREST

Dr. **Greenspan**. Senator, I think I said, at the beginning of my answer to Senator Grassley, that that is in fact the case now. For long term. For mortgage rates. For all interest rates with maturities of, say more than 10 years, because the implied inflation rate that is embodied in those interest rates is approximately 10 percent. An average annual rate of inflation of 10 percent.

So, that the only place where this concept of a high, so-called, real rate of interest is meaningful, is in the short end of the market, for 3-month debt, or 6-month Treasury bills, for example.

Senator **Quayle**. What about mortgages, long-term mortgages today; are they not 12 percent? I do not think anybody, at least I have not heard anybody in the last 10 months say they may come down to 12 percent. What are we talking about?

Dr. **Greenspan**. I think what we are talking about is which inflation rate is the applicable rate to employ when one says that the interest rate, say, is 3 percentage points over the inflation rate.

Well, it is in the following sense. The U.S. long-term Treasury rates, which is now 14 percent, is composed of approximately 3 percent of a real inflation rate, and about 1 percent of what we call instability premiums.

The rest, 10 percent, is the expected inflation rate. The difference between the 14 percent, of a U.S. Treasury instrument, and the 17 percent of a mortgage instrument is sheer risk. The reason I put it in those terms, is that when you break down the mortgage interest rate, it is still consistent with a real rate of interest, of about 3 percent.

MARKETS BEATING INFLATION

Senator **Quayle**. Let me try to summarize, and to focus in on a fundamental point that I simply do not understand. It is my understanding that most economists think inflation for the next two quarters is going to stay about 7 percent, or maybe go down a little bit. Do you disagree with this?

Dr. **Greenspan**. I would say 6 or 7 percent annual rate.

Senator **Quayle**. Now, the prime just went up, the other day.

Dr. **Greenspan**. Yes.

Senator **Quayle**. And the prime went up to what, 17 or 16 percent?

Dr. **Greenspan**. Sixteen and one-half.

Senator **Quayle**. That is a 10-percent gap in my mathematics. It is a 10-percent gap that is hurting the small businessmen in Indiana, and the farmers that are not getting the financing. I cannot explain this gap, and I notice you said there is really nothing to do, in response to Senator Grassley's question. Is this not normal?

Dr. **Greenspan**. No, it is not.

Senator **Quayle**. I guess I do not understand. You talk about long-term projection, but I am talking about residential housing. Historically, it was 2 or 3 percentage points above inflation. Now we appear to have inflation under control for a sustainable period of time, but there is no indication that these interest rates are going to go down. To me, something is wrong somewhere.

We are all beating our brains out trying to find out what to do. Maybe you can shed some light on that real situation. Those are the numbers.

Dr. **Greenspan**. OK. Let me see if I can try to go step by step.

It is true that the current inflation rate is 6 or 7 percent. It is also true that the long-term expected budget deficit has created an environment from which we can infer that the markets are assuming that the inflation rate accelerates, and in fact averages approximately 10 percent over the next decade.

As a consequence of that, long-term interest rates have risen significantly, and that is the reason why we have a 14-percent U.S. Treasury yield for, say 20-year maturities, and residential mortgages at 16 or 17 percent.

As a consequence of those very high long-term interest rates, business borrowers have, instead of borrowing in the long-end of the market, concentrated their borrowing in the short end, and that very heavy excess short-term borrowing is what has driven the prime rate up to 16.5 percent. It is in fact, a reflection of the long-term interest rate structure, which in turn is a reflection of the extraordinary change in the long-term budget deficit outlook.

Senator **Quayle**. In essence, you are saying that the markets are beating inflation, and are going to shoot back up?

Dr. **Greenspan**. Yes, sir.

CHANGE COLLECTIVE PERCEPTIONS OF INDIVIDUALS TO LOWER INTEREST RATES

Senator QUAYLE. They do not want to come down and get caught where inflation is above them, and the interest rates are below the inflation rate.

Well, you know, that may be the perception. Obviously you are very successful, and well-respected. I respect you immensely and your economic background. It seems to me that these people in the financial community are doing a real disservice to the economy, particularly the lenders at the high rates. Inflation may come back up, but it may not.

Do not interest rates have some impact on the rate of inflation itself? Can't we reestablish the historical pattern of two or three points above inflation, and overcome the expectations that are not doing anybody any good?

Dr. GREENSPAN. Well, the problem, Senator, is that millions of individuals are endeavoring to protect their own households' wealth, or the assets of a company. People lend and borrow money on the basis of their perceptions of inflation over the long run. Coupled with that is what we call risk premiums. Interest rates are generally more than 3 percent above the inflation rate. It is 3 percent plus a risk premium.

You cannot control interest rates by edict. If you promulgate from the Government an interest rate, which let us say, is less than it otherwise would be in the marketplace, you are going to find far more people who want to borrow at that rate than who want to lend. You will have a distortion similar to what we have when we impose price controls.

So what you have to do to get interest rates down, is to change the collective perceptions of individuals. I am not saying that somebody gets out there and says that, I assume the inflation rate is 10 percent, and I will not give you a long-term loan at less than 14, 15, 16 percent.

What in fact happens, is that there is a market in which one can infer what on average people must be assuming. Even though they are not even consciously aware of it.

The only way to change that is to alter the causes of their view of long-term inflation. That is one of the reasons why I strenuously argued that it is critical for us to bring down the long-term budget deficits that are now being projected implicitly, by both borrowers and lenders in the financial community. You can assume anything about their motives, but each individual is thinking as though they are acting only in their own behalf, not even aware that it has any other implications.

INTEREST RATES ARE KILLING THIS COUNTRY

Senator QUAYLE. I thank you, Dr. Greenspan, and I thank the chairman for having this outstanding witness.

I would only just state in summary a few of my own personal observations. I guess that I agree with you in theory that we cannot come up with some sort of an edict to get inflation rates down. But as just one Senator, I am so totally frustrated with these high interest rates and their great gap with inflation, that I am not putting that out of the realm of possibility. As a matter of fact, I am trying to search for ways to come up with some rational approach where we can force down, without the use of controls, because I do not like that word, these interest rates, because they are simply killing this country. They really are. You know that and I know it. We cannot—we just cannot sit here and talk all day about how terrible it is. Something is going to give somewhere, and I do not have the answer today. I do not think anybody does.

I will tell you that Federal monetary policy has always been thought of as sort of sacrosanct. You cannot touch the Federal Reserve Board, you cannot touch the interest rates. We are slowly reaching a point where somebody is going to try to do that. As I said, I will be willing to discuss it with you, and that is quite a change of opinion for this particular Senator. But I do not like it. I think it has not worked in the past, but this just cannot go on. In the next 12 months, I think inflation is going to stay about that high. We are going to talk about the deficit. I am going to work with Senator Hollings, and the chairman of our committee and others, to bring these deficits down. I am not sure that we can, I am not sure that we can change that perception, the bottom line of interest rates. It is totally frustrating to me.

I am going to vote. Thank you.

Dr. GREENSPAN. You have my sympathies, Senator.

Senator GORTON. Dr. Greenspan, you can tell by the attendance and the questions that we have greatly appreciated the fascinating and educational testimony which you have given here today. Thank you very, very much for coming.

We are under another rollcall at this point.

Dr. Hardin, we will be back as quickly as we possibly can. You can set yourself up and we will start immediately with you on our return.

[Short recess.]

Senator GORTON. Dr. Hardin, our apologies for the broken nature of today's hearing but we do now have you here and we are delighted to hear from you.

STATEMENT OF CLIFFORD M. HARDIN, DIRECTOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO.

Dr. HARDIN. Mr. Chairman, I am pleased to have the opportunity to speak to this Senate subcommittee on a subject that is indeed of growing concern, the rapid and sometimes unrestrained growth of the Federal Government's credit activities.

I should say to you, Mr. Chairman, at the outset that I am somewhat new in this field. I became about a year ago the Director of the Center for the Study of American Business at Washington University, St. Louis. For the past few months, we have been engaged in doing some research on this whole matter of Federal credit activities. So partly what I am giving you are the reactions of an outsider coming into the field. May I say that I have found a lot of surprises. After looking at the more than 350 lending programs that have been created over the past many, many years, and the backdoor financing and shadow budgets that are sometimes of great magnitude, we think what is happening is simply unaffordable for this country for the future. The volume and size of Government credit programs are virtually invisible to the public. Federal credit accounting procedures are so complicated and so misleading that only a few budget buffs are able to discover what is really occurring. Data on defaults, loan rescheduling, delinquencies and nonpayment of interest frequently are either nonexistent or purposely hidden. What is perhaps even more serious, however, is that there is no central management and almost no coordination among programs.

Now, in the time we have today, I would like to first talk about the effect of the Federal Financing Bank activity which was discussed by Dr. Greenspan.

Second, to discuss some of the adverse economic effects of Government credit activity, including again the record high interest rates; and

Third, present some recommendations for improving the control management and coordination of existing loan programs.

FEDERAL FINANCING BANK

First, the Federal Financing Bank. Originally the FFB was established back in 1974, I believe, to coordinate the sale of loans to private financial markets. After the first year, however, the Treasury Department found that it could get money more cheaply by simply buying not directly from agencies and adding the cost to the national debt rather than trying to place these notes in financial markets.

Since agency loans are no longer on agency books, that is those that are sold to the FFB, they typically have the appearance of being repaid. On the surface, therefore, it would appear that most of the agencies' loans, such as the Farmers Home Administration, about which I have some familiarity, are paid up at any particular time. But they are not paid up. They are simply being held by the Federal Financing Bank. A Government agency is still responsible for all loan defaults and for nonpayment of interest, but such defaults are not critically analyzed, and losses are handled through a separate, automatic-concept type of appropriation made each year by the Congress. This means that the agencies can go off-budget and greatly increase their scale of lending activity.

The record of the Farmers Home Administration and Rural Electrification shows how important FFB financing has been to the growth and visibility of low credit activities.

GOVERNMENT CREDIT ACTIVITY

My major point, however, concerning the growth of Federal lending activities, is the mechanism by which Federal credit activity contributes to the record high interest rates that we have seen in the past 2 years. Fairly convincing evidence of the highly adverse effects of Government credit activity can be found in the figures showing aggregate amounts of funds available in U.S. credit markets.

In 1979, the Federal Reserve Board reported that total funds raised in credit markets was $414 billion. The Federal Government absorbed nearly 34 percent of this supply of credit through three major items: the increase in the gross national debt in that year, amounting to $53 billion; private sector loans guaranteed by the Government totaling $60 billion; and loans made by Government-sponsored enterprises such as Fannie Mae and the Farm Credit Administration, totaling $28 billion. All told, Federal credit demands for 1979 were $141 billion, thus leaving $273 billion for private borrowers and State and local governments. Then, as we move into 1980 from 1979, Federal credit activities monopolized an astonishing 50 percent of the total funds, and the best current estimate for 1981 is now 53 percent. Thus, credit funds remaining for unsponsored borrowing were $273 billion in 1979, dropping to $172 billion in 1980 and rising slightly to $216 billion in 1981. These residual funds must service not only the private sector but also State and local government financing.

Now, this decrease in the residual is due, of course, partly to decreased saving, to growth in debt and growth in loans. All three were factors.

I believe it is clear then that in 1980 and 1981, when private demand for credit was very strong, something had to give and did. Credit had to be rationed, and the only way it could be rationed was through price. Hence, a period of record high interest rates began. Furthermore, unsponsored private borrowers who could not pay the price of high interest rates were crowded out of the market.

Ironically, the Federal Government, as the largest of all borrowers, could be the biggest beneficiary from a program of credit restraint simply in terms of the cost of carrying a trillion dollar national debt; each percent of interest in financing the debt at a trillion dollars costs about $10 billion. Allowing for the fact that some of the debt is long term and was entered into some years ago, the total saving by a reduction of 5 percent in interest rates, could be as much as $35 billion—a reduction of that amount in financing the debt and thus the prospective deficit.

I recall that a year ago when the budget was first presented, the estimates on carrying the debt was $90 billion. About 2 months ago, that was revised upwards to $109 billion. I think it would be a great psychological boost for our economy if indeed we could reduce our credit programs, hold interest rates down and perhaps reduce them more.

CREDIT BUDGET

Now, in the time that I have left, I want to talk about some of my recommendations for reform. My most basic recommendation for improvements in this situation is for the administration and the Congress to simply get tough on credit programs and immediately reduce expenditures and eliminate all the ones that they can. Furthermore, enforcement of effective accounting and management methods is badly needed.

In the long run, it is clear that full and adequate reporting on these programs is fundamental to attempts to control them. A study called "Credit Budget" by the Congressional Budget Office is a valuable first step in this regard. However, this proposed mechanism does not properly account for the costs of the credit programs, since no accruals are made for defaults when the loans are made and the crowding out effects of Federal credit are ignored.

The subsidies implicit in the easy loan rescheduling policies and the large degree of delinquencies in repayment are also not accounted for. These costs must be measured and should be included in the Federal budget.

This will require more uniform definitions of "default" than currently exist, and it will probably require legislation to implement. All too many Federal agencies are not sufficiently concerned about collection of their loans. In fact, many loans that default are not treated as defaults until the statute of limitations expires—thereby eliminating any possibility of recovery. And although the magnitude of these problems may not be large when compared to total Federal spending, these procedures create a climate of distrust and cynicism toward the Federal Government that is, in itself, destructive to the functioning of this Government.

One of the bills currently under consideration in Congress is H.R. 2372, and the related S. 265. Title I of the House bill proposes establishing a semiannual credit report that will provide information not only on Federal activities but also on the effects these activities have on the availability and cost of credit in the private sector. This sound idea deserves serious consideration. In addition, title III of this bill proposes that congressional oversight committees be charged with the responsibility of establishing uniform accounting standards for programs within their separate jurisdictions. Our proposal goes beyond this concept by recommending that uniformity be mandated across all programs and, also, that the credit programs be monitored by some central agency, rather than being left in the domain only of the oversight committees.

Further, some changes need to be made so that Congress does indeed review and approve the full extent of Federal credit activities. Any such proposal should deal with the current off-budget status of the FFB. Rather than putting the FFB on-budget—which would induce some double-counting—I wish to support the extention of the current CBO "Credit Budget" to a system of targets and controls, such as envisioned in title II of H.R. 2372. The gross obligations for direct loans and gross commitments—and possibly obligations as well—for quaranteed loans need to be limited by congressional actions. If these levels are controlled at the source, then there is little additional need to control their financing through the FFB as well, and particularly would this be true if the FFB could serve only as a source of borrowing for the agencies and not as a direct lender itself.

COMPARABLE INTEREST RATES

Quite separate from the budget control aspects of the problem is the irrationality of the interest rates charged in current credit programs. Rather than setting a rate in legislation, such as the 5-percent charged for Farmers Home Rural Housing loans, interest rates should be tied to the Treasury cost of borrowing money. I am not, however, arguing for the removal of all subsidies. But Federal credit should not operate contrary to monetary and fiscal policy, as it does now. Rather, it should reflect a more consistent set of credit prices than it does at present. When private mortgage rates were 6 percent in the 1950's, the 5-percent Farmers Home rate may have been reasonable. But, in 1982, with mortgage rates at 16 to 18 percent, the result is both irrational and inequitable.

Finally, I also believe that the preparation and passage of a comprehensive Federal Credit Act should be a high priority item for both the Congress and the White House in 1982. Many beneficial reforms cannot be effected without the backing of law, and if this can be accomplished, the benefits to the Nation's economy will certainly be substantial. Thus, Congress and the White House must jointly recognize and attack the morass of Federal credit activities, not only to eliminate the perverse effects of Federal lending programs on interest rates and Federal deficits, but also to reduce interference with normal market forces.

Thank you, sir.

Senator GORTON. Dr. Hardin, I thank you.

PREPARED STATEMENT OF CLIFFORD M. HARDIN,* DIRECTOR, CENTER FOR THE STUDY OF AMERICAN BUSINESS, WASHINGTON UNIVERSITY, ST. LOUIS, MO.

INTRODUCTORY REMARKS

I am pleased to have the opportunity today to speak to this Senate subcommittee on a subject of growing concern -- the rapid and unrestrained growth of the federal government's credit activities. These programs have now brought about "backdoor financing" and "shadow budgets" of great magnitude, and they are simply no longer affordable in our country. The volume and size of government credit programs are virtually invisible to the public. Federal credit accounting procedures are so complicated and so misleading that only a few budget "buffs" are able to discover what is happening. Data on defaults, loan rescheduling, delinquencies and non-payment of interest frequently are either nonexistent or purposely hidden. What is perhaps even more serious, however, is that there is no central management and almost no coordination among programs.

During the past decades, Congress has created more than 350 different federal loan programs. Each program was created for a specific purpose and, in most instances, for purposes that seemed sound and laudable at the time. But with the passage of time and with the interaction of special interest groups -- each group reacting to its own incentives, which are not necessarily

---

*Dr. Clifford M. Hardin is Director of the Center for the Study of American Business at Washington University, St. Louis. The Center published a more extensive report on this subject in December 1981, entitled *The Unrestrained Growth in Federal Credit Activity* by Dr. Hardin and Dr. Arthur T. Denzau, visiting research associate at the Center.

the same as the entire country's -- members of Congress and government officials have converted those small, special-purpose programs into things that bear little resemblance to the original.

In the time that I have today, I would like to: 1) outline the tremendous growth in federal credit programs; 2) discuss some of the adverse economic effects of government credit activity, including the record-high interest rates the nation has experienced in the past two years; and 3) present some recommendations for improving the management and coordination of existing loan programs.

THE EXPANSION OF CREDIT ACTIVITIES

Direct Loans, On-Budget and Off-Budget

To provide some background, I would first like to discuss direct loans recorded in the budget (Table 1, column 1, attached). These on-budget direct loans have doubled in magnitude in seven years -- from over $12 billion in 1974 to nearly $26 billion in 1980. Unfortunately, these figures are only the tip of the "credit iceberg," and this tip is often obscured by reducing these figures for repayments and defaults and by shifting loans "off-budget." In January 1979, a Congressional Budget Office publication stated, "The only credit activities currently included in the budget totals are direct loans on-budget by on-budget agencies, and they are included only on a net basis." The CBO further stated that "of the $159 billion of federal and federally sponsored credit activity shown for fiscal year 1979, only $4.3 billion, the direct net lending, is included in the budget totals."

Conversely, direct loans made off-budget are a relatively new phenomenon, compared with on-budget direct loans. They came about with the creation of the Federal Financing Bank (FFB) in the Treasury Department, which finances these loans. From a modest beginning as a $3.5 billion program in 1974, direct loan programs, off-budget, grew to $32 billion in 1981 (Table 1, column 1). Off-budget, direct loans now account for approximately 20 percent of federal credit activity, and nearly all of these loans are made through the FFB. Originally, the FFB was established to coordinate the sale of loans to private financial markets. After the first year, however, the Treasury Department found that it could get money more cheaply by simply buying notes directly from the agencies and adding the costs to the national debt, rather than by trying to place those notes in financial markets.

Furthermore, the FFB has no discretion in deciding which agency loans to accept. Provided that an agency guarantee its loans against default and non-payment of interest -- something the agencies are always willing to do -- the FFB must purchase these loans if it is asked to do so. Therefore, an agency, with a fixed budget, can go to the FFB as soon as it has reached its budget ceiling, have its credit replenished, and then have billions of dollars to loan *again*. An agency can do this as many times a year as it wants; there is, in short, no limit whatsoever to its lending capability.

Indeed, since agency loans are no longer on agency books, but rather on the books of the FFB, they have the appearance of being repaid. On the surface, therefore, it would appear that most of an agency's loans -- such as those of the Farmers Home Administration -- are paid up at any particular time. But they are *not* paid up; they are simply being held by the Federal Financing Bank. A government agency is still responsible for all loan defaults and for non-payment of interest, but such defaults are not critically analyzed, and losses are handled through a separate, automatic-consent type of appropriation made each year by Congress.

Guaranteed Loans

Guaranteed loan activity, the third area of federal lending, has now spread throughout government. A host of agencies can make guaranteed loans for a variety of purposes. The volume of these loans has increased rapidly in the three years between 1978 and 1981, from $45.5 billion to an estimated $70 billion in the last fiscal year (Table 1, column 3).

Many of the newer guaranteed loan programs are poorly managed -- for instance, the student loan program. I believe the intent of this program was laudable, and certainly the need was evident. Though the program is not large, it has become almost a national scandal. Most of its difficulties are caused by faulty program design. For example, student loans that are made by banks and other institutions are fully guaranteed for both principal and interest by the government. As a result, there is no incentive for the lenders to assess risk. Furthermore, nothing is to be gained by vigorously pursuing repayment of delinquent loans.

The cumulative effect of federal credit activity can be seen in the fact that an estimated $623 billion in loans will be outstanding (unpaid at year-end) in fiscal 1982. And although there is no way to predict the default rate on that $623 billion, it is certain to be sizeable. As a result, a large potential deficit exists here that will have to be paid by direct annual appropriations by Congress at some point.

FEDERAL CREDIT ACTIVITY AND INTEREST RATES

My major point, however, concerning the growth of federal lending activities, is the mechanism by which federal credit activity contributes to the record-high interest rates that we have seen in the past two years.

Fairly convincing evidence of the highly adverse effects of government credit activity can be found in figures showing aggregate amounts of funds available in U.S. credit markets (Table 2, attached). In 1979, the Federal Reserve Board reported that total funds raised in credit markets was $414 billion. The federal government absorbed nearly 34 percent of this supply of credit through three major items: (1) the increase in the gross national debt in that year, amounting to $53 billion; (2) private-sector loans guaranteed by the government totaling $60 billion; and (3) loans made by government-sponsored enterprises (such as "Fannie Mae," the Farm Credit Administration, and others) totaling $28 billion. All told, federal credit demands for 1979 were $141 billion, thus leaving $273 billion for private borrowers and state and local governments. In 1980, federal credit activities monopolized an astonishing 50 percent of the total funds, and the best current estimate for 1981 is 46 percent. Thus, credit funds remaining for unsponsored borrowing were $273 billion in 1979, but only $172 billion in 1980, and $216 billion estimated for 1981. These residual funds must service not only the private sector but also state and local government financing.

I believe it is clear, then, that in 1980 and 1981, when private demand for credit was very strong, something had to give -- and did. Credit had to be rationed, and the only way it could be rationed was through *price*. Hence, a period of record-high interest rates began. Furthermore, unsponsored private borrowers who could not pay the price of high interest rates were "crowded out" of the market.

Ironically, the federal government -- as the largest of all borrowers -- could be the biggest beneficiary from a program of credit restraint. Let me illustrate what it could mean in terms of the cost of carrying the gross national debt. Last February, when the President sent his revised 1982 Budget to Congress, the cost of financing (paying interest on) the debt was estimated at $90 billion. Late in 1981, that figure was reestimated, in the light of higher interest rates, to be $109 billion, an increase of $19 billion. On a trillion-dollar national debt, each percent of interest costs about $10 billion. Some debt issues involve long-term financing, thus reducing the effect of reductions in current interest rates, but if interest rates can be brought down 5 percent, about $35 billion should be saved in financing the debt and, thus, reduce the projected budget deficit. That would be a psychological boost for our economy, if indeed this could be accomplished in fiscal 1982.

RECOMMENDATIONS FOR REFORM

In conclusion, I would like to discuss some recommendations for improvements. The first and foremost proposal is for the Administration and Congress to get tough on credit programs and immediately reduce expenditures or eliminate all the ones they can. Furthermore, enforcement of effective accounting and management methods is badly needed.

A Credit Budget

In the long run, it is clear that full and accurate reporting on these programs is fundamental to attempts to control them. The "Credit Budget" of the Congressional Budget Office is a valuable first step in this regard. However, this mechanism does not properly account for the costs of the credit programs, since no accruals are made for defaults when the loans are made and the crowding-out effects of federal credit are ignored.

The subsidies implicit in the easy loan rescheduling policies and the large degree of delinquincies in repayment are also not accounted for. These costs must be measured and should be included in the federal budget. This will require more uniform definitions of "default" than currently exist, and it will probably require legislation to implement. All too many federal agencies are not sufficiently concerned about collection of their loans. In fact, many loans that default are not *treated* as defaults until the statute of limitations expires -- thereby eliminating any possibility of recovery. And although the magnitude of these problems may not be large when compared to total federal spending, these procedures create a climate of distrust and cynicism toward the federal government that is, in itself, destructive.

One of the bills currently under consideration in Congress is H.R. 2372 (and the related S. 265). Title I of the House bill proposes establishing a semiannual Credit Report that will provide information not only on federal credit activities but also on the effects these activities have on the availability and cost of credit in the private sector. This sound idea deserves serious consideration. In addition, Title III of this bill proposes that Congressional oversight committees be charged with the responsibility of establishing uniform accounting standards for programs within their separate jurisdictions. My proposal goes beyond this concept by recommending that uniformity be mandated across all programs and, also, that the credit programs be monitored by some central agency, rather than being left in the domain only of the oversight committees.

Further, some changes need to be made so that Congress does indeed review and approve the full extent of federal credit activities. Any such proposal should deal with the current off-budget status of the FFB. Rather than putting the FFB on-budget -- which would induce some double-counting -- I wish to support the extension of the current CBO "Credit Budget" to a system of targets and controls, such as envisioned in Title II of H.R. 2372. The gross obligations for direct loans and gross commitments (and possibly obligations as well) for guaranteed loans need to be *limited* by Congressional actions. If these levels are controlled at the source, then there is little additional need to control their financing through the FFB as well. Such a comprehensive scheme will obviously add another burden to the Congressional budgeting process, but it is a proposal that deals systematically with the lack of control and oversight of federal credit activities.

Comparable Interest Rates

Quite separate from the budget control aspects of the problem is the irrationality of the interest rates charged in current credit programs. Rather than setting a rate in legislation, such as the 5 percent charged for Farmers Home Rural Housing Loans, interest rates should be tied to the Treasury cost of borrowing money. I am not, however, arguing for the removal of all subsidies. But federal credit should not operate contrary to monetary and fiscal policy, as it does now. Rather, it should reflect a more consistent set of credit prices than it does at present. When private mortgage rates were 6 percent in the 1950's, the 5 percent Farmers' Home rate may have been reasonable. But in 1982, with mortgage rates at 16 to 18 percent, the result is both irrational and inequitable.

Finally, I also believe that the preparation and passage of a comprehensive federal credit act should be a high-priority item for both the Congress and the White House in 1982. Many beneficial reforms cannot be effected without the backing of law, and if this can be accomplished, the benefits to the nation's economy will certainly be substantial. Thus, Congress and the White House must jointly recognize and attack the morass of federal credit activities, not only to eliminate the perverse effects of federal lending programs on interest rates and federal deficits, but also to reduce interference with normal market forces.

TABLE 1

Annual Federal Credit Outlays
Fiscal Years 1974-1982
(billions of current dollars)

Fiscal Year	Direct Loans On-Budget	Direct Loans Off-Budget	Guaranteed Loans	Total
1974	$12.3	$ 3.5	$31.8	$47.6
1975	12.9	10.8	31.1	54.8
1976	18.8	10.2	31.8	60.9
1977	14.7	13.6	43.3	71.6
1978	23.5	16.4	45.5	85.4
1979	21.0	17.3	60.5	98.8
1980	25.7	23.6	68.7	118.0
1981 est.	24.6	32.2	70.0	126.8
1982 est.	28.1	26.2	90.0	144.3

Note: Outlays do not include loans issued by federally sponsored agencies or by federal enterprises. All figures have been rounded. Outlays for the Transition Quarter (July-September 1976) have been omitted.

Source: *Center for the Study of American Business*

TABLE 2

How Unrestrained Federal Credit Activity Contributed to High Interest Rates in 1980 and 1981

(billions of current dollars)

	1978	1979	1980	1981
	(fiscal year, October 1 to September 30)			
1.) Total Funds Raised in U.S. Credit Markets	$385	$414	$345	$410*
2.) Annual Total Increase in Gross National Debt	71	53	80	84
3.) Private-Sector Loans Guaranteed by Government (primary loan transactions)	45	60	69	70*
4.) Government-Sponsored Enterprise Loans, Net (Fannie Mae, Farm Credit Administration, etc.)	25	28	24	34*
5.) Total, Lines 2, 3 & 4	141	141	173	188
6.) Percent, Line 5 of Line 1	37%	34%	50%	46%
7.) Balance of Funds Available to the Private Sector, State & Local Governments	244	273	172	216

* Estimated

Note: The increase in federally guaranteed loans, plus net increases from both government-sponsored enterprises and the growth in the national debt, significantly limited the supply of funds available to the private sector. During the period in which private-sector demand for credit remained strong, interest rates rose to record-high levels, thus raising the cost of money -- not only to the private sector but to government as well.

Source: *Center for the Study of American Business*

REDUCED CREDIT DEMANDS AFFECT INTEREST RATE LEVEL

Senator **Gorton**. Your testimony indicates that you believe the record high interest rates of the previous year are due, to a large extent, to the unprecedented levels of Federal credit demands. Do you believe that a reduction in the direct loan, or loan guarantee levels, would by itself result in a drop in interest rates?

Dr. **Hardin**. It depends on the size of the budget deficit, because it has a crowding out effect also. It is our feeling that in 1979 and 1980, moving into 1981, that at that particular time the very, very rapid growth in both the—well, the FFB financing and the guaranteed loans did put pressure on, and did crowd out many private borrowers, and did raise interest rates.

Now, if we could reduce this pressure, it would contribute toward holding interest rates down, but if at the same time we raise the budget deficit, which has to be financed by $30 million, or $40 million, it would offset the effects of loan reductions.

Senator **Gorton**. I will make my question a little more precise. If there were a net reduction in demands on credit, do you have any way of judging, estimating, or even guessing at the reduction in the general interest rate level, for say each $20 billion, which would take the Federal Government out of the credit market?

Dr. **Hardin**. I think there are so many variables there that you cannot make a flat statement about it. You can only talk about direction. But it certainly would be helpful and wholesome to the economy, and would contribute to a reduction in general interest rates.

Also, if we could increase the rate of savings, and there are prospects that this may happen, this would also provide some relief to lowering interest rates.

I think there are two or three significant things that happened in the past few months. I think there was a drop in demand in the private sector, all right, but I think there was also some restraint exercised by the administration in the past 12 months, particularly in the guaranteed loan area, and this restraint, in environment may have contributed to this softening of interest rates that we had in the past—well, 3 months.

But now, as Dr. Greenspan pointed out, as we discussed earlier, with the increased pressure, or increased prospects of a large deficits, you offset much of that.

LEGITIMATE CREDIT ACTIVITY

Senator **Gorton**. One other question. Obviously a formal credit budget, as you have outlined it, would be a great deal of help in giving us an understanding of what was happening, and probably almost certainly would result in certain limitations on direct loan obligations and direct loan commitments which are made almost willy-nilly at the present time. Nevertheless, I am sure you would say that there are some areas in which some kind of credit intervention is appropriate. I take it that you are not advocating the termination of all commercial credit activities in the agricultural area?

Dr. **Hardin**. Quite the contrary.

Senator **Gorton**. Do you have any way in which you could help us define what a legitimate credit activity on the part of the Federal Government is, and why there are such legitimate activities in the field of agriculture?

Dr. **Hardin**. Well, I think that it takes a little background to discuss that, but so often the Congress has created a loan program for very good and solid reasons that we all applaud, and then, over the passage of years, the eligibility, or the numbers of people entitled to participate gets broadened and broadened and broadened, and it becomes a—well, it loses any sense of its original purpose.

I think we saw this in some of the poverty loan programs, that were started back in the late sixties. Hard core poverty areas were identified in something like 20 percent of the counties across the Nation which included about 29 million people. A few years later this was expanded until poverty areas were defined for 85 percent of the counties that included 190 million people. Even Greenwich, Conn., received a poverty loan.

Well, this sort of thing happens. I think we need to go back, in some instances, to the original purpose for these loans, and recalculate, look at what has happened, and see if we cannot bring them back to the original purpose. Certainly this is true in the Farmers Home Administration, where credit is being used for purposes that were not originally intended, and not high priority, I suspect, by most of our judgments.

I do not know how you would do it specifically, but I think it has to be done through some kind of control of the numbers, limits that the Congress would place on the programs.

Senator **Gorton**. Dr. Hardin, I thank you very much for both your patience and your enlightening testimony.

Dr. **Hardin**. I appreciate the opportunity of presenting our material to you.

Senator **Gorton**. Thank you.

We will next hear from Mr. Warner.

STATEMENT OF MINER H. WARNER, VICE PRESIDENT AND MANAGER, GOVERNMENT FINANCE GROUP, SALOMON BROS., INC.

Mr. **Warner**. Good afternoon, Mr. Chairman.

I welcome this opportunity to testify. I do not think that I am going to read from my testimony.

Senator **Gorton**. It will all be included in the record.[1]

Mr. **Warner**. Which I do recommend to the attention of the committee, and also I have included pages from the OMB report of January 1981, which I for one find very illuminating.

I thought what I would like to do, merely is summarize the major points verbally, and start with, I think that document that all of us find of some interest recently, that was published by the Congressional Budget Office this January, entitled "The Federal Financing Bank and Budgetary Treatment of Credit Activity."

I noticed, however, that there were two major points that were not at all treated in this study, and I wanted to raise them, because I think they are important.

---

[1] See p. 129.

COST OF FUNDING FFB THROUGH TREASURY

My testimony, by the way, is solely with respect to FFB. The first point is, how much does FFB actually cost the Government. In the past, I believe that there has been an implication that FFB runs the "Matched Book," but that is not the case.

FFB has a "Matched Book" between itself and Treasury, but between Treasury and the assets being funded, there is no "Matched Book."

FFB, in this regard then, is analogous to a savings and loan institution, which lends fixed rate, and borrows short. The resulting mismatch, of course, is history.

I guess, on a number of conservative estimates, we come up with an indicated figure that in the past fiscal year, this mismatch may have cost the Treasury about $1.4 million. I would imagine, also, that a loss of that magnitude from the mismatched book would be expected in the coming fiscal year.

I hasten to add, of course, that had this portfolio of FFB assets been financed through the public market, this loss to Treasury would not be there. Borrowers, whether it be agencies or guaranteed borrowers, would have funded out at historic rates, and those losers would have been investors who had taken at earlier rates.

TAX EFFECTS OF FUNDING AGENCY AND GUARANTEED DEBT THROUGH FFB

At any rate, they would not be an element, as there is here, of funding short and lending long. The second point I would like to mention, which again is covered in the study, is the question of taxes.

Guaranteed obligations are subject not only to Federal, but also to State and local taxes. The FFB portfolio at the present time, for fiscal 1981, was about $30.9 billion. That means $30.9 billion of assets, which but for having gone to FFB, would have been subject to State and local taxation. This is a significant revenue item on the State and local level.

Again, had these publications gone on the public sector, there would not have been this potential revenue loss.

A point has been made, from time to time, in the testimony here, I believe, although not today, that there really is no difference in the market between a direct Treasury bill, note or bond, and an agency or guaranteed issue.

IMPACT OF FFB FUNDING THROUGH DIRECT TREASURY DEBT

Well, I will not address myself to the crowding out theory which has been discussed eloquently by Dr. Greenspan, but from a market point of view, I wish to emphasize very clearly that Treasurys are the benchmark price for all issues in the capital markets. All borrowers who finance fixed rate, finance in relation to Treasury.

The Province of Ontario, they are priced in so many basis points above Treasuries, General Motors, a utility here in the District of Columbia area. By contrast, in the capital markets people are not looking at the guaranteed level, and they are also not pricing against quasi-Federal agencies.

In terms of pricing benchmarks then, agency and guaranteed debt is decidely different than that of Treasurys. So in the past fiscal year, FFB, in essence, converted certainly in the case of guarantees, guarantees into direct loans, funded through direct Treasurys.

As you know, there was $21 billion of direct Treasury issuance by reason of FFB purchases. That meant $23 billion after public markets. The benchmarks were increased by a benchmark or $21 billion, and there were costs involved. There were costs to the borrowers in the market, and interestingly, also, and I cannot quantify this, there were costs in the U.S. Federal debt by definition.

This is a point which has been raised inferentially, but I thought it an important one, to consider it. The first two points I have seen discussed nowhere before.

I might add, as just supplementing that third point, that typically in the markets, the lowest yields are obtained by direct Treasurys, this is because of continuous large issuance, large outstandings, something we call fundability, that is to say all obligations of Treasury have the same terms, same structure. The only difference is between the initial yield or coupon.

And because of the first two foregoing, there is a high degree of liquidity, very broad secondary market. Since the seventies, the quasi-Federal agencies—and by quasi-Federal agency, I mean full faith in credit, that includes the agencies which currently finance the public market, but also include the two agencies which have had access, and continue to finance through FFB.

The market has developed, I would say, with respect to the quasi-agencies, and there is considerable liquidity, and size in those markets. Far and away, the most liquid, however, are the Treasury markets. The guaranteed markets, by contrast, always sold at rates higher than Treasury, and typically higher than quasi-markets, because on balance they are smaller sized, they lack fundability, and they lack liquidity.

VIEWS OF CONGRESS REGARDING FFB

The growth of the FFB, of course, was not unnoted by Congress, and it is interesting to recollect that during the past 4 years, the three major guaranteed programs which have been enacted by Congress in fact expressly precluded the use of FFB.

Starting in this fiscal year, or rather with the change in administration, between the congressional intent expressed in these three major acts over the past 4 years, the OMB study of January 1981, a statement by the Secretary of Treasury in May of this year, with respect to the first issuance of discount notes by Sallie Mae, some reason was given to expect that the activities of FFB in fact would diminish, and there might in fact be some return, by some of those borrowers, that the Secretary indicated in connection with Sallie Mae to the public markets.

Since that time, two major guaranteed projects, both in the synfuel area, whose guarantees were authorized under earlier statute, and not the Energy Security Act, which precludes FFB purchase, have been placed into the bank, and so a question simply is raised, is it business as usual?

ROLE OF BANKERS AND FINANCIAL INTERMEDIARIES

I think I would like to add two further points. One is a little advertisement for investment bankers, commercial bankers—free time here. Qualified borrowers who have access to FFB, can, of course, go to FFB, and in the maturities that are permitted by their governing statutes. But what they do not get FFB is any advice as to timing, and timing is something which is very important indeed.

For example, during the past 3 years, the high/low yield change in 10-year treasuries has been on the order of 255 basis points.

I frequently see changes of 30 basic points in a given day. It is quite possible then, without advice, to be getting it all wrong. Bankers hopefully are more proficient than some other professionals actually in following rate trends and market developments.

The net effect of having some financial advisory, and intermediary assistance could be very useful, and could in fact result in savings to borrowers, who currently use FFB.

I hasten to add that use of FFB by borrowers severely constrained refinancing possibilities by them.

NOT POSSIBLE TO ABOLISH FFB

I would like to conclude merely by saying that it is not really possible at this stage to abolish FFB. Because FFB is going to continue to have a portfolio which, I suppose, is in excess of $110 billion right now, continue to fund, and that cannot be wished away.

In addition, FFB has a number of contractually binding agreements with borrowers which entail financing in future years, which amount to billions of dollars. It is a little known fact, but it is so.

So FFB, or its successor, is going to be responsible for in excess of $100 billion of financing for quite some time to come.

What is possible, however, would be to have a lessening of FFB activity by having certain of the more qualified borrowers, classified agencies, or the large guaranteed borrowers, return to the public markets, and as I indicated earlier, it would be, of course, three clear beneficial results, one would be a lessening of the mismatch book cost.

Second would be a growth in the tax base of State and local taxation. Third, of course, would be the lessened competition with agency and guaranteed borrowers in public market, with a financing of the national debt by reason of the different investment characteristics of agencies to guaranteed debt.

I thank you you very much, Mr. Chairman.

Senator GORTON. I thank you. That was most enlightening.

PREPARED STATEMENT OF MINER H. WARNER, VICE PRESIDENT AND MANAGER, GOVERNMENT FINANCE GROUP, SALOMON BROS., INC.

Mr. Chairman and Members of The Committee:

My name is Miner H. Warner and I am Vice President and Manager of Government Finance at Salomon Brothers Inc, an investment bank which has long been active in the government securities markets. I have first-hand experience with guarantee programs which finance in the public market and through The Federal Financing Bank (FFB) and with the "non-full faith and credit" quasi-Federal agencies which finance in the private sector and through FFB. On behalf of clients, I have negotiated with Treasury the terms and conditions of major guaranteed issues sold both in the public market and to FFB. My introduction to Government Finance dates from 1971 when I worked with William E. Simon, then at Salomon Brothers, subsequently Secretary of the Treasury, on a number of Federal Agency issues.

A. Introduction

I welcome this opportunity to present some thoughts concerning the financing of Federal credit activities, specifically some thoughts regarding FFB. As you well know, this is a complex area. Relatively little has been written on FFB and, indeed, information as to its activities and practices is not widely available. I hope to keep investment banker's market-

PLACE JARGON TO A MINIMUM. I PROPOSE TO FIRST ADDRESS TWO TOPICS INVOLVING FFB WHICH I DO NOT BELIEVE HAVE BEEN PREVIOUSLY COVERED IN TESTIMONY BEFORE THE TASK FORCE AND THEN PROCEED TO SOME WHICH HAVE.

B. FEDERAL FINANCING BANK

1. THE COST OF FUNDING FFB THROUGH TREASURY

HOW MUCH DOES FFB COST THE TREASURY? TYPICALLY, FFB'S FEE OF 1/8 OVER THE COST OF TREASURY'S OWN DEBT NET OF MINIMAL FFB ADMINISTRATIVE EXPENSES HAS BEEN COUNTED AS FFB PROFIT. THEREFORE, IN FY '81 FFB INDICATES A GROSS PROFIT ON THE ORDER OF $122.9 MILLION ON AN AVERAGE PORTFOLIO OF APPROXIMATELY $98.4 BILLION. AT FISCAL YEAR END, THE PORTFOLIO STOOD AT $107.3 BILLION. THIS "PROFIT" ASSUMES THAT FFB MAINTAINS A "MATCHED BOOK"; THAT IS, THAT THE MATURITIES OF ITS LOANS ARE PERFECTLY MATCHED BY ITS SOURCE OF FUNDS. FFB, INDEED, MAINTAINS A MATCHED BOOK AS BETWEEN ITSELF AND TREASURY, THE SOURCE OF ITS FUNDS. BUT TREASURY DOES NOT HAVE A MATCHED BOOK AGAINST ITS LOANS TO FFB.

THE FINANCIAL PRINCIPLE HERE IS SIMPLE AND VERY EXPENSIVE. TREASURY/FFB LOANS LONG AND FUNDS SHORT AND HAS BEEN DOING SO SINCE THE CREATION OF FFB IN 1974. TO BE SURE, A SMALL AMOUNT OF FFB'S LOANS ARE VERY SHORT-TERM OR MONEY MARKET PRICED INSTRUMENTS, NOTABLY to such borrowers as Student Loan Marketing Association (Sallie Mae), TVA-Seven States Energy Corp., Amtrak and a small portion of Eximbank debt. However, the bulk of FFB's portfolio is intermediate to long-term. By definition, by the way, Treasury's funding of FFB's loans cannot be matched as FFB purchases certain guarantees, such as REA guarantees, whose maturity, at 35 years, is longer than Treasury bonds.

An unmatched book as the savings and loan industry knows is, and has been over the past three years, very costly. The arithmetic is easy to calculate on a portfolio of approximately $100 billion. Every full percentage point (or one hundred basis points) of interest represents $1 billion. Capital markets in the mid-1970's when FFB began its operations were characterized by a positive yield curve, that is, short-term money was cheaper than long term. Initially, Treasury's funding of FFB's portfolio was profitable. The past three years have been characterized by a negative yield curve, with shorter term money being more expensive than long-term. And, in addition, the absolute level of rates has risen steeply. But I state the obvious.

On the basis of a number of conservative (i.e., loss reducing) assumptions which we have made, we believe that the funding of FFB's portfolio in FY '81 alone may have cost Treasury approximately $1.4 billion. I would also anticipate a loss of that magnitude in FY '82.

Had this portfolio been funded in the public market, there would have been no loss to Treasury as there would have been no funding risk.

2. Tax Effects of Funding Agency and Guaranteed Debt through FFB.

Agency assets, both full faith and credit and non-full faith and credit agency debt and guaranteed debt which FFB purchases would, if sold in the public market, be subject to tax. Interest on Agency assets and Agency debt is subject to Federal income tax but is generally exempt from state and local income taxes. Interest on guaranteed debt is, however, subject to both Federal and state and local income taxes. While Federal income taxes paid on interest on Treasury borrowings to finance FFB can be assumed to roughly equal the taxes which would have been paid in interest on Agency and guaranteed debt if it had been sold in the public market, FFB's conversion of guaranteed debt

TO TREASURY BORROWINGS RESULTS IN A LOSS OF REVENUES TO STATE AND LOCAL GOVERNMENTS BECAUSE INTEREST ON TREASURY BORROWINGS IS EXEMPT FROM STATE AND LOCAL TAXATION. GUARANTEED DEBT IN FFB'S PORTFOLIO AT THE END OF FY '81 TOTALS $30.9 BILLION AND IS GROWING SIGNIFICANTLY.

FUNDING GUARANTEED DEBT IN THE PUBLIC MARKET WOULD HAVE RESULTED IN ENHANCED STATE AND LOCAL REVENUE.

C. THE IMPACT OF FFB FUNDING THROUGH DIRECT TREASURY DEBT: AGENCY AND GUARANTEED DEBT IS NOT INTERCHANGEABLE WITH DIRECT TREASURY DEBT.

FUNDING OF FFB PURCHASES IS CARRIED OUT BY THE MARKETING BY TREASURY OF A MIX OF TREASURY BILLS, NOTES AND BONDS (TREASURIES). IN FY '81 FFB'S PORTFOLIO INCREASED $24.75 BILLION. TREASURY ISSUED AN ADDITIONAL $21 BILLION OF TREASURIES TO FINANCE SUCH PURCHASES IN EXCESS OF DEBT ISSUED TO FINANCE THE DEFICIT, $3.75 BILLION BEING ALREADY INCLUDED FOR BUDGETARY PURPOSES IN THE BUDGET TOTALS. LET US ASSUME THAT IN THE ABSENCE OF FFB, PART OF SUCH AGENCY ASSETS, AGENCY DEBT AND GUARANTEED DEBT WOULD HAVE BEEN FINANCED IN THE PUBLIC MARKET. I SAY PART OF SUCH DEBT ADVISEDLY. IN MY OPINION, SOME BORROWERS WOULD

HAVE BORROWED LESS, GIVEN PREVAILING MARKET VOLATILITY AND HIGHER RATES TO WHICH THEY WOULD HAVE BEEN SUBJECT IN THE PUBLIC MARKET. THEREFORE, LESS AND PERHAPS CONSIDERABLY LESS, THAN THIS AMOUNT WOULD HAVE BEEN MARKETED.

A QUESTION POSED IS WHETHER THERE IS ANY DIFFERENCE IN PUBLIC MARKET IMPACT BETWEEN, SAY, TREASURIES AND GUARANTEED DEBT. THERE MOST CERTAINLY IS.

THE MARKET FOR TREASURIES IS ENORMOUS. GENERALLY SPEAKING, THE MARKET FOR TREASURIES IS CHARACTERIZED BY: REGULAR PRIMARY ISSUES, THAT IS, FREQUENT ISSUANCE BY TREASURY OF NEW TREASURIES; FUNGIBILITY, THAT IS THE TERMS OF ALL TREASURIES OF COMPARABLE MATURITY ARE THE SAME EXCEPT FOR ORIGINAL YIELD; AND LIQUIDITY, THAT IS, THE COMBINATION OF FREQUENT NEW ISSUES OF TREASURIES, THE FUNGIBILITY OF TREASURIES AND THE VAST VOLUME OF OUTSTANDING ISSUES ASSURES VERY FINE SECONDARY MARKET TRADING. SIZE, FUNGIBILITY AND LIQUIDITY -- THESE ASSURE THAT TREASURIES, WHICH ARE THE HIGHEST QUALITY CREDIT IN THE CAPITAL MARKETS BEING DIRECT DEBT OF THE UNITED STATES OF AMERICA, ARE THE PRICING BENCHMARK FOR ALL OTHER ISSUERS. A GENERAL MOTORS DEBT ISSUE IS PRICED TO YIELD SO MANY BASIS POINTS OVER (OR ABOVE) TREASURIES. A WORLD BANK ISSUE IS PRICED AT SO MANY BASIS POINTS OVER

TREASURIES. AS IS A PROVINCE OF ONTARIO ISSUE, A KINGDOM OF SWEDEN ISSUE, A CITICORP ISSUE, AND A DISTRICT OF COLUMBIA UTILITY ISSUE. THE BASIS POINT RELATIONSHIP MAY VARY, BUT TREASURIES ARE THE BENCHMARK.

BY CONTRAST, AGENCY AND GUARANTEED DEBT IS NOT A PRICING BENCHMARK. WHILE THE MARKET FOR QUASI-FEDERAL AGENCIES, MOST OF WHICH FINANCE IN THE PUBLIC MARKET (BUT TWO OF WHICH CONTINUE TO FINANCE THROUGH FFB), HAS BEEN CHARACTERIZED BY FUNGIBILITY AND HAS DEVELOPED LIQUIDITY SINCE THE EARLY 1970'S, GUARANTEED DEBT SOLD IN THE PUBLIC MARKET HAS LACKED TO A GREATER OR LESSER DEGREE FUNGIBILITY AND LIQUIDITY. DIFFERENT GUARANTEE PROGRAMS HAVE VERY DIFFERENT TERMS AND, SOMETIMES, DIRECT CONSTRAINTS ON SECONDARY MARKET TRADING. OF COURSE, THEY HAVE ALSO BEEN SUBJECT TO STATE AND LOCAL TAXATION. IT IS NOT SURPRISING, THEN, THAT IN THE PUBLIC MARKET, TYPICALLY TREASURIES HAVE ALWAYS HAD THE LOWER YIELD, FOLLOWED BY QUASI-FEDERAL AGENCIES, FOLLOWED BY GUARANTEED DEBT DESPITE THE FACT THAT GUARANTEED DEBT IS BACKED BY THE "FULL FAITH AND CREDIT OF THE UNITED STATES".

GUARANTEED DEBT BY A SINGLE ISSUER HAS NEVER BEEN OF A SIZE IN THE PUBLIC MARKET TO ENSURE MAJOR LIQUIDITY. THE LARGEST GUARANTEED BORROWER IN THE PUBLIC MARKETS HAS BEEN CHRYSLER CORPORATION FOR $1.2

BILLION. THE THREE GUARANTEED CHRYSLER ISSUES IN 1980 AND 1981 CONTAINED UNUSUAL PROVISIONS WHICH TREASURY REQUIRED BUT WHICH DEVIATED FROM STANDARD MARKET PRACTICE, AND IN ADDITION THERE WAS AT THE TIME OF MARKETING UNCERTAINTY AMONG SOME INVESTORS AS TO THE EXPECTED DURATION OF THE GUARANTEED DEBT. THE CITY OF NEW YORK GUARANTEE WAS SOMEWHAT LARGER BUT PLACED ENTIRELY WITH NEW YORK CITY AND STATE PENSION FUNDS. THE LOCKHEED GUARANTEES WERE FINANCED THROUGH THE COMMERCIAL BANKS, NOT THE PUBLIC MARKET. THE LARGEST GUARANTEED ISSUE IN THE PUBLIC MARKET, I BELIEVE, HAS BEEN THE ONE-TIME $367 MILLION ISSUE IN 1976 FOR THE NATIONAL POWER CORPORATION OF THE PHILIPPINES GUARANTEED BY EXIMBANK. BEYOND THAT, THE LARGEST GUARANTEED DEBT WOULD DATE BACK TO THE MID-1970'S, A $200 MILLION ISSUE OF GUARANTEED MERCHANT MARINE BONDS, KNOWN IN THE MARKETPLACE AS TITLE XI BONDS. THE LARGEST TITLE XI ISSUE BY FAR MARKETED DURING THE PAST FOUR YEARS HAS BEEN FOR $110 MILLION.

IT IS EVIDENT THAT THE GUARANTEED DEBT MARKETS HAVE BEEN CHARACTERIZED BY RELATIVELY SMALL BORROWERS, LACK OF FUNGIBILITY AND RELATIVE LACK OF LIQUIDITY. IT IS ACCURATE TO CONCLUDE THAT PUBLIC MARKET PURCHASERS OF GUARANTEED DEBT HAVE DIFFERENT INVESTMENT

GOALS THAN PURCHASERS OF HIGHLY LIQUID TREASURIES. IT ALSO FOLLOWS THAT GUARANTEED DEBT DOES NOT COMPETE FOR THE SAME PURCHASERS AS THOSE WHO INVEST IN TREASURIES.

TREASURIES ARE THE PRICING BENCHMARKS FOR THE ENTIRE CAPITAL MARKET. THE MARKET EFFECT OF FFB HAS BEEN TO REQUIRE IN FY '81 AN ADDITIONAL $21 BILLION OF ISSUANCE OF TREASURIES WITH NEGATIVE CONSEQUENCES AS TO THE PRICE LEVEL OF TREASURIES WHICH IN TURN IMPACTS NEGATIVELY ON ALL FINANCING IN THE UNITED STATES CAPITAL MARKET. THIS, OF COURSE, CAN ADD MEASURABLY TO THE COST OF FINANCING THE NATIONAL DEBT.

D. THE GROWTH OF FFB

THE ORIGINAL CONCEPT OF FFB WAS TO ACT AS A CENTRAL BORROWING CONDUIT FOR AGENCIES WHICH HAD BEEN FINANCING IN THE PUBLIC MARKET. FFB WOULD FUND ITS ACTIVITIES THROUGH PUBLIC MARKET BORROWING. INSTEAD, AFTER ONE ISSUE, IT TURNED TO TREASURY FOR ITS FUNDING. ONE EFFECT OF THIS WAS THAT IT WAS REMOVED FROM THE SCRUTINY OF THE PUBLIC MARKET. IT GREW AND GREW. WHILE THE SECRETARY OF THE TREASURY HAS STATUTORY AUTHORITY TO DENY FFB ACCESS TO OTHERWISE QUALIFIED BORROWERS WITH THE SINGLE EXCEPTION OF REA GUARANTEES DUE TO 1981 AMENDMENTS, SUCH AUTHORITY

HAS NEVER BEEN USED. ORIGINALLY, I BELIEVE, THE FFB USER FEE WAS 3/8 BUT BY THE MID-1970'S THAT HAD BEEN REDUCED TO 1/8. MOST OF THE TIME FOR THE QUASI-FEDERAL AGENCIES AND ALL OF THE TIME FOR GUARANTEED BORROWING IT REPRESENTED THE CHEAPEST SOURCE OF FINANCING.

IN CERTAIN RATE ENVIRONMENTS THE SAVINGS BY BORROWERS WERE MODEST OR NEGLIGIBLE. THE UNMATCHED BOOK RISKS ASSUMED BY TREASURY/FFB WERE NOT. FOR QUALIFIED BORROWERS UNDER THE FEDERAL FINANCING BANK ACT, FUNDS WERE ALWAYS AVAILABLE AND IN ANY MATURITY AUTHORIZED BY AGENCY OR GUARANTEE PROGRAM STATUTE. IN THE PUBLIC MARKET THERE MIGHT BE A MARKED RELUCTANCE FOR LONG MATURITIES, OR THE MARKETS MIGHT BE IN DISARRAY. PUBLIC MARKET RESTRAINTS AND DISCIPLINE WERE NOT RELEVANT TO QUALIFIED BORROWERS EXCEPT THAT OF ABSOLUTE INTEREST LEVELS PLUS 1/8.

THE CHEAP INITIAL COST OF FUNDS THROUGH FFB WAS NOT ALWAYS IN THE BORROWER'S INTEREST AS, IN EXCHANGE, THE BORROWER GAVE UP FOR ALL PRACTICAL PURPOSES ITS RIGHT TO REFINANCE. FFB PRACTICE FORECLOSED REFINANCING AT A LATER DATE AT LOWER INTEREST RATES, AND PRECLUDED BORROWERS FROM PREPAYING DEBT PRIOR TO MATURITY.

E. Views of Congress Regarding FFB

The growing prominence of FFB in the financing of guaranteed debt did not escape notice by Congress. The effect, of course, of FFB purchase of loan guarantees is to convert a contingent liability involving no direct outlay of funds, with the borrower required to permanently fund the guarantee through the public market and the investor subject to rate movement and risk, to a direct loan by FFB involving a direct outlay by FFB financed through the sale of additional Treasuries. Interestingly, the major new guarantee programs of the past four years, City of New York, Chrysler, and the Energy Security Act (1980) which provided for the creation of the Synthetic Fuels Corporation all expressly prohibited the use of FFB. The trend was clear. In 1981, Sallie Mae entered the public market with a successful issue of discount notes and the Secretary of the Treasury noted in a speech that spring that this Quasi-Federal Agency was a "prototype" of FFB borrowers which would return to the public market. Since then, no further borrowers have left. Indeed, two major guaranteed borrowers, whose guarantees were authorized under the Defense Production Act (1950), as amended, and under the

FEDERAL NON-NUCLEAR RESEARCH AND DEVELOPMENT ACT (1974) WHICH DID NOT EXPRESSLY EXCLUDE FFB HAVE BEEN FINANCED THROUGH FFB.

IS IT STILL "BUSINESS AS USUAL"?

F. THE ROLE OF BANKERS AND FINANCIAL INTERMEDIARIES

THE USE OF BANKERS IN ADVISING AND UNDERWRITING CERTAIN CURRENT FFB BORROWERS COULD RESULT IN CONSIDERABLE COST SAVINGS TO BORROWERS. FFB GIVES NO INTEREST RATE ADVICE TO BORROWERS. BANKERS ARE, HOPEFULLY, MORE PROFICIENT THAN OTHER PROFESSIONALS IN MARKET DEVELOPMENTS AND INTEREST RATE TRENDS. HEIGHTENED MARKET VOLATILITY PLACES A PREMIUM ON INFORMED ADVICE. WHILE ANNUAL FLUCTUATIONS IN THE HIGH AND LOW IN YIELDS ON 10 YEAR TREASURIES IN THE MID-1970'S AVERAGED 99 BASIS POINTS, THE AVERAGE RANGE DURING THE PAST THREE YEARS HAS BEEN 255 BASIS POINTS.

ANOTHER DECISION THAT BANKERS CAN EFFECTIVELY ADVISE ON IS MATURITY SELECTION.

THE TRUE COST OF BANKERS' COMMISSIONS IS EXAGGERATED RELATIVE TO YIELD SAVINGS. NOT INFREQUENTLY, I SEE CHANGES IN YIELDS ON TREASURIES OF 30 BASIS POINTS IN A DAY'S TRADING. THE COST TO A BORROWER OF A PLACEMENT COMMISSION OF 1/2% ON A 15% 15 YEAR DEBT INSTRUMENT COMES TO 8.5 BASIS POINTS.

THE AGENCIES AND MOST GUARANTEED BORROWERS WHICH ACCESS FFB ALREADY HAVE IN PLACE FINANCE STAFFS TO MANAGE BORROWING AND DISBURSEMENT ACTIVITIES. THE MECHANICS OF TRANSITION FROM FFB TO THE PUBLIC MARKET COULD, THEREFORE, BE ANTICIPATED TO BE SMOOTH.

I RECOMMEND TO YOUR ATTENTION THE OMB DEBT COLLECTION PROJECT: REPORT ON STRENGTHENING FEDERAL CREDIT MANAGEMENT DATED JANUARY, 1981, PAGES 62-76 WHICH COVERS FFB AND, TO SOME DEGREE, THE ROLE OF BANKERS. THIS SECTION IS ATTACHED AS APPENDIX I TO MY TESTIMONY.

G. ALTERNATIVES

THERE ARE A BROAD RANGE OF ALTERNATIVES REGARDING FUTURE FFB ACTIVITIES. REGARDLESS OF WHAT ALTERNATIVE IS DECIDED UPON, FFB OR ITS SUCCESSOR IS CONTRACTUALLY COMMITTED TO BOTH THE FUNDING OF ITS PRESENT PORTFOLIO AND TO FUTURE FINANCING WITH CERTAIN BORROWERS WHICH HAVE CONTRACTUALLY BINDING COMMITMENTS WITH FFB WHICH RUN INTO BILLIONS OF FUTURE DOLLARS.

IT CAN BE ASSERTED THAT CERTAIN GUARANTEED DEBT, SUCH AS DHUD-PUBLIC HOUSING NOTES, BECAUSE OF TAX REASONS, OR DOD-FOREIGN MILITARY SALES, BECAUSE OF THE MARKETING DIFFICULTIES INHERENT IN FINANCING MILITARY SALES IN THE PUBLIC MARKET, SHOULD REMAIN IN FFB.

H. CONCLUSION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, THIS CONCLUDES MY TESTIMONY. I GREATLY APPRECIATE HAVING HAD THE OPPORTUNITY TO FOCUS ON ONE ASPECT OF FEDERAL CREDIT POLICIES, NAMELY, FFB.

THANK YOU.

CHAPTER V

SPECIAL ISSUES

A. FEDERAL FINANCING BANK

1. Background

The Federal Financing Bank (FFB) was established in 1973 to serve as a intermediary for the financing of obligations issued, sold, or guaranteed by government agencies. Its primary function is to coordinate and assist agency borrowing needs. The FFB has authorrity to obtain funds by selling its own securities in the priave market or it may borrow from the Treasury. As a matter of practice, the FFB obtains all its funds by borrowing from the Treasury. It is important to remember that FFB transactions are excluded by law from the budget totals and thus its lending activities are not treated as budget outlays and do not affect the budget deficit.

FFB purchases of government guaranteed borrowings of private entities is one of the most troublesome aspects of FFB activity. Normally under these arrangements, FFB makes loans directly to the private borrower whose obligations are guaranteed by a government agency. These guaranteed loans in actuality become direct federal loans outside the budget even though they are shown in agency accounts as "guaranteed loans."

The FFB, therefore, holds a key role in financing and managing lending by the Federal government and in assisting Federal agency borrowing generally. The importance of the FFB in these activities is illustrated by the fact that the FFB's lending activities accounted for $48.7 billion or 28 percent of the $175 billion in government receivables at September 30, 1979.

The growing impact of the FFB and certain of its lending practices have raised concerns about its activities. To address these concerns and assess the overall soundness of FFB activities from a credit management/debt collection perspective, the Debt Collection Project analyzed the FFB operations, the condition of its protfolio, and certain of its major loans.

Following is a summary of the Debt Collection Project findings and recommendations relative to the Federal Financing Bank. The detailed Project report on the Federal Financing Bank is published under separate cover.

2. Analysis of FFB Financings

The FFB financings analyzed by the Debt Collection Project included:

- NASA Space Satellite Communications System
- TVA Nuclear Fuel Lease Arrangement
- Health Maintenance Organizations
- Rural Electrification Administration
- GSA Building Acquisitions
- Defense Security Assistance Agency Guaranteed Loans

These financings were chosen because they are representative of the different types of FFB transactions. Additionally, a general assessment was made of the status of the FFB's portfolio. This included analyzing the percentage of the FFB's loans that were in a nonperforming status where the borrower was not meeting the original terms of the loan.

a. NASA Space Satellite Communications System

In 1976, NASA awarded to Western Union a $786 million contract in the form of a 10 year lease to own and operate a Tracking and Data Relay Satellite System (TDRSS) that will furnish telecommunications service to the agency. Western Union will also be able to use a portion of the system to furnish service to its commercial customers. The construction and launch costs for the entire system (estimated in 1976 at $586 million exclusive of interest) are being financed by the FFB.

NASA guaranteed "...through contract terms and conditions..." repayment of the FFB loan to Western Union "...subject only to the normal risk involving actual appropriations being made available on a timely basis...". NASA, moreover, pledged unconditionally to the FFB to make all debt service payments and all liability payments for the satellite system in the event of termination by NASA or default by Western Union.

Technically, this is a guaranteed loan. NASA is guaranteeing a loan for Western Union that is being funded by the FFB. In effect, NASA appears to be obligating funds in advance of appropriations. Moreover, from a budgetary standpoint, the contract is not fully funded at all. There has been no Congressional appropriation and no OMB apportionment. No appropriation of funds will be requested by NASA for TDRSS until the system is operational in 1983. It is the sense of the Debt Collection Project that this situation raises three fundamental legal issues.

- First, it is questionable whether the FFB could have accepted a NASA contract, even if fully funded, as an acceptable form of guarantee for the loan to Western Union.
- Secondly, it is not clear that NASA had specific authority to issue any sort of guarantee, much less one that takes the form of a fully funded contract.
- Lastly, since the contract was not fully funded, it appears that the FFB has made an unauthorized loan.

There is also another questionable legal issue here. In the June 19, 1975 Authorization Act for NASA that included TDRSS, Congress directed that the government shall incur no costs under such contract. In fact, the government has already incurred costs in the form of interest expense paid on FFB/ Treasury borrowings to finance the Western Union loan. The Debt Collection Project estimates that these costs are in the neighborhood of $60 million.

From the perspective of the original procurement decision, the initial analysis for the lease versus purchase decision seems to have been incomplete for three reasons. First, NASA did not consider in its analysis the alternative where the satellite system would be financed by a tax exempt institution such as a FFB. In using the FFB, all savings to NASA under the lease alternative are costs to the FFB and the Treasury. Therefore, with FFB financing, the purchase alternative should always be cheaper to the Government; yet, the NASA analysis concluded that a lease should be undertaken.

Secondly, the tax consequences may have not been fully analyzed. By retaining title to the system, Western Union may be able to generate a tax shield of about $300 million by claiming the investment tax credit and depreciation. Even if the lease is treated as an installment sales agreement by the Internal Revenue Service, Western Union's profits are taxed at the capital gains rate, rather than its marginal corporate tax rate. Finally, it is not clear why NASA should be extending an interest free loan to Western Union by funding the private portion of the investment costs. By using the FFB, this private portion also counts against the public debt limit.

As a result of the NASA arrangement with Western Union, Western Union has become a competitive leader with what it describes as the "...most powerful domestic communications satellite system in operation."

b. TVA Nuclear Fuel Lease
October 31, 1979, the Tennessee Valley Authority (TVA) entered a 30 year lease with the Seven States Energy Corporation whereby TVA will sell its nuclear fuel inventory to Seven States and later lease it back as needed. Concurrently, TVA arranged through the FFB a 5-year guaranteed loan with a $2.0 billion limit for Seven States to use in purchasing the nuclear fuel. The loan is priced according to 91-day Treasury bill rates. The initial drawdown on the loan was $490.6 million.

Because of nuclear plant construction slowdowns, utilities such as TVA have greater nuclear fuel inventory than needed and than financially prudent. The sale/lease-back arrangement allows TVA to treat the financing costs for its excess fuel inventories and the related debt as off-balance sheet items. As a result, this allows TVA to meet certain interest coverage and operating cost ratios that are mandated in its enabling legislation.

TVA had engaged Goldman Sachs, an investment banking firm, to develop a similar financing approach that would have been funded from the private commercial paper market with Bankers Trust backing up the commercial paper with a revolving bank credit. Goldman Sachs planned to raise up to $1.0 billion for TVA in this fashion with the initial tranche being $400 million. Then the Treasury Department apparently suggested to TVA that the FFB could provide the financing and a $2.0 billion facility was agreed upon.

A private utility's accumulation of nuclear fuel would be subject to credit review either by the commercial paper purchasers or by the commercial banks in the revolving credit. However, the FFB performed no independent credit review. Moreover, the financing has been structured in such a way that no financial risk has been passed to the fuel lessor, Seven States, or the lender, the FFB because TVA has guaranteed the loan.

TVA entered into the lease arrangement with Seven States pursuant to its authority to lease property as provided in the Tennessee Valley Authority Act. The sense of the Debt Collection Project is that TVA and the FFB are taking a very liberal interpretation of the TVA legislation. It is not clear that a lease is sufficient authority for the FFB to make the loan. It can be argued that the lease is a form of collateral, but it is not a guarantee. It also can be argued that Seven States is not really a lessor, but just a bookkeeper. Moreover, nuclear fuel may not be considered "property" because it is a disposable item. The question is how can TVA "lease" disposable property which it will consume?

Lastly, the FFB provided TVA with a potential interest rate subsidy of up to $20.0 million annually by funding the lease at three month Treasury bill rates, rather than the more expensive commercial paper rates. Moreover, TVA is saving $6.8 million annually by not paying a commitment fee on the nuclear fuel facility's $1.3 billion undrawn balance at June 30, 1980. It is not clear, in fact, why the pricing of the loan should not be equivalent to private sources of funds. TVA customers are, in effect, receiving interest rate subsidies from the Federal government.

c. Health Maintenance Organization (HMO) Loan Activity HMO's have been established to extend specific health services for a fixed, pre-paid fee. A revolving fund of $35.0 million provides funding for HMO loans up to $4.0 million apiece to cover operating losses in the first five years of operation. The HMO loans are sold to the FFB in order to replenish the revolving fund. The FFB had $96.0 million of HMO loans in its portfolio at June 30, 1980.

During the Debt Collection Project review of Office of Health Maintenance Organization (OHMO) activities, these conditions were observed:

- OHMO had not defined formal loan policies and guidelines;
- OHMO did not have a loan monitoring system; and,
- Loan and grant administration procedures varied between headquarters and regions.

Private lenders would have required these types of financial controls. A private lender would also have required the provision of loan loss reserves. The assumption that all loans will be repaid is generous even when a financial institution is lending to established companies with substantial credit records. Since, loans were being made to new HMO's pioneering a new concept, OHMO should have been required to set up loss reserves and to develop effective loan monitoring practices. This sort of situation substantially increases the probability of loan defaults.

Defaults have occurred and the situation is becoming progressively worse. OHMO has repurchased $11.8 million in defaulted loans from the FFB. These included $2.4 million of defaults in FY 1979 and another $9.4 million as of April 1980. At least ten loans totaling $16.4 million are due and payable in July 1980. Between $3.5 million and $12.1 million of these loans were expected to be defaulted upon. While the revolving fund is limited to $35.0 million, the purchase of its loans by the FFB means there is no effective limit on the amount of OHMO guarantees. In effect, however, the FFB is assuming a credit risk for all loans losses over $35.0 million, yet a reserve for potential losses has not been established by the FFB.

d. Rural Electrification Administration Funding

At March 30, 1980, the Rural Electrification Administration (REA) had $16.7 billion in loans outstanding to finance rural electric and telephone utilities. REA funds itself by selling guaranteed obligations to the FFB and then acts as the Bank's agent in servicing the loans.

In 1972 and 1973, Congress passed legislation to reduce the impact of the REA loan program on the Federal budget. Based on this legislation, the REA/FFB funding arrangement would appear to violate congressional intent in these ways:

- The impact on the budget is not reduced. The FFB funds its REA obligations through the Treasury which in turn sells securities to the public. These security sales are counted towards the public debt limit, even though the monies are used to fund the REA's off-budget, guaranteed loans.
- Credit from private sources has not been substituted for Federal credit. The FFB is a wholly-owned government entity. The FFB is financing all of the REA guaranteed loans to the complete exclusion of private lending institutions.

The FFB could have worked with REA to develop alternative funding mechanisms for efficiently packaging REA's small and numerous loans. A Government National Mortgage Association (GNMA) mortgage backed security program allows individual mortgages to be pooled into a package that serves as collateral for a security that is large enough to be marketed to private institutional investors. The mortgage collateral is pledged to GNMA in return for a Federal guarantee of the security that is ultimately sold to the institutions. The same model might be used for the REA loans. REA could continue to originate and service the rural utility and telephone loans and then use them as collateral for guaranteed securities that could be sold to private institutional investors. This would not involve appropriated funds or count against the public debt limits.

Another alternative for a model funding mechanism might be the one offered by the Farm Credit System. The banks of the Farm Credit System are chartered by the government and operate under Federal law. The Farm Credit System funds its loans by issuing securities in the private capital markets. At June 30, 1978, the Farm Credit System had issued $42.9 billion of securities. The capital markets view these securities as non-guaranteed, government agency debt, but they are not appropriated in the budget nor do they count against the public debt limit.

By helping REA evolve in the direction of GNMA or the Farm Credit System, the FFB would be acting as a financial adviser, rather than as an actual funding mechanism. This role would appear to be consistent with the intent of Congress to eliminate REA's impact on the budget by substituting private sources of funding for Federal credit.

e. GSA Building Acquisitions

In the mid-1970's, GSA sold $697.1 million of participation certificates to the public to finance and construct government buildings. Another $534 million of participation certificates were sold to the FFB.

In 1979, the trustee for the public issues issued "events of default" notices because about $7 million of certificates were not properly redeemed to meet mandatory sinking fund payments. The incorrect computation of the annual payments occurred because these computations were based on a percentage of the face amount of certificates rather than on the principal amount of purchase price, which included certificate proceeds and interest earned thereon.

GSA had to deposit funds with the trustee to resolve the asserted defaults. If payment of the $374 million of outstanding certificates in the two defaulted issues had been accelerated, necessary refinancing of the issues would have cost the government $7.5 million in higher interest rates the first year.

GSA also had been redeeming certificates at par to annual sinking fund requirements. The certificates, however, were selling below par in the secondary market where GSA could have bought them.

Even though GSA had no experience in the field of public debt management, it did not draw upon the Treasury's expertise. Instead, GSA paid $1.5 million in fees for professional services from a special counsel, a financial advisor, and a commercial bank trustee.

f. General Assessment of the FFB Portfolio

In order to make a general assessment of the FFB portfolio, a review was made of nonperforming loans. In generally accepted banking terms, a nonperforming loan is one where the borrower does not have the ability to meet the contractural terms of the loan. A nonperforming loan in the private sector can take one of two forms:

- Nonaccrual basis where interest income and principal repayment are recognized only to the extent cash is received.
- Renegotiated basis where the loan is being serviced regularly by the borrower, but at a rate of interest or on a repayment schedule different from those originally contracted for.

For the Federal government, there are two other forms of nonperforming loans that also should be considered. One is where the interest and principal payments are being made by the credit originating agency because the borrower does not have the ability to service the loan. The other is where a loan is being liquidated by a congressional appropriation because the borrower is unable to repay the loan.

The general assessment of the overall FFB portfolio at September 30, 1980, indicated that 5.3% of the loans are in a nonperforming status. This amounts to $4,355 million of nonperforming loans out of a $82.0 billion portfolio and they fall into the following categories:

- $1,223 million of loans have had their payments and/or maturities rescheduled because the borrowers were not able to meet the original contractual terms of the loans.
- $2,677 million of loans that will have to be liquidated by congressional appropriations because the borrowers are unable to repay the loans.

- $455 million of loans where interest and principal payments are being made by the originating agency, rather than by the borrowers.

3. Findings and Conclusions of the Debt Collection Project

The Debt Collection Project concludes that the FFB has contributed to a deterioration of credit management by Federal agencies. Some critical management activities are not being performed well, and credit responsibilities of the originating agency, the FFB, and the OMB are blurred.

a. Role of FFB Board and Advisory Group

At present, the FFB Board of Directors is drawn entirely from within the Treasury Department.The Board members include:

(1) Secretary of the Treasury
(2) Deputy Secretary
(3) Under Secretary of Monetary Affairs
(4) General Counsel
(5) Fiscal Assistant Secretary

There have only been two or three formal board meetings since the FFB was founded in 1974. On the other hand, some of the board members meet informally as part of the weekly Financing Group meetings. At no time does there appear to have been formal board minutes kept of these meetings.

The FFB legislation provides that the Board of Directors shall determine the general policies for the operations of the bank and the duties of the officers. However, the legislation does not direct that the five person board come from within the Treasury. The Secretary of the Treasury must be the Chairman of the Board, but the other four shall be appointed by the President from any Federal agency or from the FFB staff.

The FFB also has an Advisory Council which was created by Presidential Executive Order in 1974. The Council was to provide advice and assistance to the board as well as serve as a coordinating forum to broaden support for the FFB. The membership of the Council consist of:

(1) Secretary of the Treasury (Chairman)
(2) Secretary of Agriculture
(3) Secretary of Commerce
(4) Secretary of Health and Human Services
(5) Secretary of Housing and Urban Development
(6) Secretary of Transportation
(7) President of the Export-Import Bank of the United States
(8) Postmaster General

The Council has been completely inactive and there has never been a formal meeting of the Council.

b. Staffing

The FFB presently has 3 full-time executives. It relies upon the Treasury's Bureau of Government Financial Operations to provide the accounting and recordkeeping support needed to maintain the FFB's portfolio.

As discussed later in the section on financial advice, the FFB does not have any personnel who are responsible for providing advisory services to the agencies. The FFB feels it can draw upon the staff of other offices in the Treasury if needed.

The Congressional legislation clearly allows for such staffing arrangements by permitting the FFB to charge borrowers for operating and servicing costs. The bank's FY 1979 income of $115 million is more than sufficient to pay for additional staff.

c. Credit Review Procedures

The FFB has no credit review procedures. The operating management of the FFB does not see credit review as one of the bank's responsibilities. Instead, the responsibility for credit review is left with the originating agencies. Also, the FFB does no ongoing monitoring of loans nor any overall financial evaluation of programs.When agencies approach the FFB, the FFB, within the limits of its charter and resources, only reviews the guarantee to ensure that the FFB bears no risk of loss.FFB performs no screening or analysis of the program being financed, the borrower's ability to repay, the real costs of benefits to the government of the funding arrangement, and, the alternate use of private market financing for the program. The FFB relies on the agencies to perform these analyses. This practice, in effect, removes checks and balances on the originating program agencies which frequently are under considerably greater pressure to extend Federal credit than to manage it.

As proven by the individual loans reviewed by the Debt Collection Project, this practice has the potential for (1) failure to design into the loan guarantee the essential elements of risk sharing, (2) use of Federal funds when private credit is available, and (3) lack of analysis of the full cost/saving to the Federal government as a result of these financing arrangements.

d. Credit Risk Sharing

The FFB operates as though it does not assume any credit risk because each loan is guaranteed by the originating agency. If a loan is defaulted upon, the FFB sells it back to the agency. Consequently, the FFB has made no provisions for loan loss reserves nor has it requested any agencies to set up loss reserves.

Regardless of the agency guarantees, the FFB is assuming credit risks. As a matter of fact, the FFB has indicated that it recognizes the risks involved and that it may have some bad loans, paticularly in credits extended to certain railroads. If a guarantee had to be enforced, the FFB would classify the loan on its financial statements as an account receivable until Congress could appropriate the money to reimburse the FFB. This procedure, however, still does not get at the issue of providing for poor credit risks.

e. Provision of Financial Advice

The FFB does not have, and does not want to have, the capability to provide financial advice to the agencies on structuring loans or developing financing plans, even though the FFB Act gives the FFB authority to approve:

- the method of financing;
- the source of financing;
- the timing of financing; and,
- the financing terms and conditions.

The bank does not view this as its function,even though it is clearly authorized in the bank's legislation.

The Treasury has the role of advising agencies on specific financings if asked or if authorized. The Treasury, on the other hand, cannot provide either the breadth or depth of advice that a leading investment banking firm can provide to its clients. Treasury's main strengths are limited to advising on marketing programs and on certain tax matters.

f. Pricing Policy

The FFB charges borrowers a uniform one-eighth of one percent fee over and above the Treasury's cost of borrowing. The FFB charge does not reflect the credit worthiness of the borrowers or the varying degrees of risk involved in different programs. The interest charge on a loan to a high risk borrower is based on the same formula as the interest charge on a loan to a low risk borrower. The benefits to the borrowers of this pricing policy can be substantial and often constitute additional subsidies or benefits to the borrowers.

Again, the FFB legislation provides for flexibility in the FFB's pricing policy. The only restriction on loan yields is that the interest rate shall not be less than Treasury or FFB issues of comparable maturity. Also, the FFB is authorized to charge fees for its commitments and other services.

g. Guaranteed Loans

One of the bank's fastest growing activities is the FFB purchases of agency guaranteed borrowings for private entities. Normally, under these arrangements FFB makes loans directly to the private borrower whose obligations are guaranteed by a government agency. These guaranteed loans, in actuality, become direct Federal loans outside the budget, even though they show up in agency accounts as "guaranteed loans." The government, through the FFB, becomes the direct lender in the "guaranteed programs" and assumes all the risks.

Based upon Debt Collection Project interviews, it is clear that the agencies recognize the FFB to be a convenient source of funds for their private sector borrowers. Funding provided by the FFB for the guaranteed programs is off-budget and does not affect agency outlays or the Federal budget deficit. A typical agency attitude is the one expressed by the Defense Security Assistance Agency: "In recent years (since 1975) preference has been given to guaranteed loans, which are financed 'off budget', and, therefore, direct loans receivable are on the decline".

As a result, guaranteed loan programs funded by the FFB are increasing rapidly. Guaranteed loans in the FFB portfolio totaled $14.4 billion in FY 1979 and are estimated to total $24.0 billion in FY 1980 and $30.9 billion in FY 1981.As a result of this growth, the financing of guaranteed loans has become a major part of the FFB's operations.

The Debt Collection Project views the FFB's purchases of guaranteed loans as one of the bank's most troublesome activities. In the most basic sense, the FFB is allowing the agencies to approve loans to themselves without an independent credit review.Other concerns about the FFB's guaranteed loans include:

- o Neither the agencies nor the FFB view themselves as being accountable for the guaranteed loans. Generally, the agencies do not view themselves having responsibility for the guaranteed loans once they are sold to the FFB. On the other hand, the FFB does not view itself at risk for these guaranteed loans since the agencies are obligated to repurchase them in the event of default.

- o The direct budget impact of the guaranteed loans is obscured because the FFB's guaranteed loans are not reflected in the budget deficit. Moreover, if a guaranteed loan goes bad, Congress must appropriate to the agency the funds necessary to reimburse the FFB. In effect, Congress is presented with a budgetary equivalent of an accomplished fact by the agency and the FFB. Congress has no direct control over the FFB's guaranteed loan activities, but must fund these loans in every respect if a default occurs.

- The FFB funding removes the opportunity for local involvement in the financing of guaranteed loans. In the case of HMO's, for example, funding for their guaranteed loans might be available from local economic development authorities, city and state governmental development authorities, or city and state governmental units. For the REA and TVA loans, private financial institutions almost certainly would have financed these guaranteed loans. Not only would this have generated tax revenues for the government from the private lenders' earnings, but it would have drawn financial resources from sectors of the capital market other than those that ordinarily invest in Treasury securities.

- There is a growing trend in the government that guaranteed loan sales to the FFB are not reported on the originating agency's financial statements. This accounting approach understates the actual level of liabilities that guaranteeing agencies have incurred and thus does not reveal a complete picture of the agency's total exposure to loan defaults and repurchase requirements. For example, the OHMO statement of financial condition as of September 31, 1979, listed outstanding direct loans as $25.77 million. However, outstanding loans of $83.64 million previously sold to the FFB were not reported on this statement. The omission of such a substantial contingent liability greatly understates the financial condition OHMO faces as guarantor of the loans. A continuation of the present default trend, necessitating futher OHMO loan repurchases from the FFB, would impact the continuation of the program. OHMO is likely to exceed its congressionally mandated appropriation limits unless additional funding is obtained from Congress.

- o The Debt Collection Project believes that the FFB's primary responsibility was to coordinate and assist agency borrowing needs and not to become a direct lender for guaranteed programs. The original intent of the Administration and Congress in most of these guaranteed loan programs was to reduce or eliminate direct Federal loans and to substitute private funding for those programs. However, this has not occurred because of the FFB's lending activities.

4. Alternative for the Future

The FFB reduces the issuance and interest costs for agency debt, and by converting agency paper into Treasury issues, the FFB has eliminated problems of market coordination. Unfortunately, while achieving these important objectives, the FFB has created new problems and exacerbated existing difficulties with the control over Federal credit activities and the management of the Federal debt portfolio. Some critical management activities are not being performed well, and credit responsibilities of the originating agency, the FFB, and the OMB are blurred. Moreover, the entrance of the FFB into the guaranteed loan market created the situtation where "direct loans" through the FFB are not included in the budget totals as is the case with similar direct loans made through on-budget agencies. There are two alternatives to correct this situation:

- o One alternative is to abolish the FFB while strengthening credit management in the agencies, Treasury, and the OMB. This will require clarifying responsibilities and instituting new procedures that will allow agencies to borrow directly from the Treasury when appropriate. One procedure would be a credit review of major loans and credit programs to ensure that there is a reasonable assurance of repayment and that loans are structured and funded in the best interests of the government. Since Treasury and OMB have agreed that credit review was OMB's responsibility, OMB would perform these credit reviews. Other procedures would include providing credit management advice to agencies as needed and ensuring that adequate provisions are made for loan loss reserves.

- The second alternative is to centralize all agency credit review and management activities in the FFB while minimizing the involvement of Treasury and the OMB. This will necessitate the development of the FFB into an independent functioning bank. The Board of Directors would be restructured and activated and would take an active role overseeing the policy of the bank. Specific recommendations are contained in the detailed FFB report prepared by the Debt Collection Project.

Either of these alternatives fills the valid role of coordinating agency borrowings and providing related financial advice to the agencies. Otherwise, and is presently the case, the FFB is little more than a bookkeeping operation that could be replaced by authorizing the agencies to borrow directly from the Treasury.

5. Recommendation of the Debt Collection Project

The Debt Collection Project recommends that the FFB be abolished. Building the FFB into an operating bank would simply duplicate functions and responsibilities that can be, and should be, performed in Treasury and the OMB. Moreover, the FFB does not want to assume an operating role or to expand its present staff.

Abolishing the FFB will require legislation. While awaiting enactment of such legislation, OMB and Treasury should agree upon administrative actions to control certain of the FFB's questionable activities. The administrative actions should be instituted immediately. One of these actions might be to have OMB review and approve all guaranteed loans that the FFB wants to fund. Another action might be to define strictly what is an acceptable guarantee. These controls can then guide the activities of the FFB until it is abolished and procedures are developed by OMB and Treasury to manage agency debt financings in the future.

FORMAL CREDIT BUDGET LIMITING ACTIVITY

Senator **Gorton**. A formal credit budget is designed to control the level of Federal Financing Bank activities by limiting the amounts of direct loan obligations and loan guarantee commitments of the agencies using the FFB. Do you think that such a formal credit budget limiting activity at the source is sufficient to control the drawbacks in the FFB system which you outlined, or do we need direct controls in addition?

Mr. **Warner**. Well, I have indicated in my testimony, and let me add here that a decision with respect to who has access to FFB is twofold: first of all, the borrower's assets need to qualify under the Financing Act and, second, the Secretary of the Treasury is not to use his discretion, which he has, with only one exception now, to curtail access. So that with respect to FFB activities, the Secretary of the Treasury has the right on balance to deny access to FFB borrowers. So a solution is in place.

The one exception I referred to is in, I believe, the amendments of 1981. The REA guaranteed borrowers represent the largest single program in FFB, are able now to request the Secretary, and the Secretary does not have discretion to use FFB. Obviously if there was a lid put on how much FFB could fund each year, then that would have some credit impact.

FUNCTION OF FFB

Senator **Gorton**. Would you simply outline what you consider the important function of the FFB to be?

Mr. **Warner**. Well, conceptually, FFB was created to be a super agency, and the idea, and in fact this mismatched book would never have come into being had the original conception held true. The concept was that FFB would lend to various agencies which in the early seventies had been going into the public market and would itself fund its activities. Of course, the super agency would be subject to scrutiny. It would not be quite clear what was developing over time. Unfortunately, after one solitary issue of short-term bills which on the street were known as funny bills, no reason for it, but that is the informality of the street speaking, FFB decided instead to do away with its own issue, not exercise the statutory discretion to build up reserves against bad loans or what have you, and head toward Treasury for financing.

I would suggest there are many alternatives available, the whole gamut, but I think that a partial solution for the future—because the past is now history and a considerable burden—would be to have the better qualified and the larger agencies, quasi-Federal agencies and the larger guaranteed borrowers be required to finance in the public sector. I note at the end of my testimony that there are a couple of programs that I am aware of which, one, for tax reasons, and the other because of the relative market ability of a particular program should, in my view, remain in FFB.

I think what is required here would really be a microeconomic analysis program by program in certain judgments taken. But, as I say, the mechanism for that is already in place and has been with the act. The Secretary of the Treasury has the discretion to curtail access to FFB, with that one exception.

Senator **Gorton**. Thank you very much, Mr. Warner. We appreciate your coming down here and your enlightening testimony.

Mr. **Warner**. Thank you.

Senator **Gorton**. Dr. Fralick.

STATEMENT OF JAMES S. FRALICK, VICE PRESIDENT, ECONOMIC ANALYSIS DEPARTMENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

Dr. **Fralick**. The release of the administration's fiscal year 1983 budget, on February 6, makes this a good time to consider budgetary procedures for the control of Federal credit programs. The large unified budget deficits now projected for fiscal years 1982 and beyond have made financial markets increasingly anxious as they contemplate a huge rise in Treasury offerings from $79 billion last year to almost $120 billion in the current fiscal year.

PROSPECT OF HUGE FEDERAL CREDIT DEMANDS

Compounding this problem is the continued rise in Federal credit activities. When net guaranteed loans and net sponsored agency borrowing are added to the Treasury's offerings, the total credit needs of the Federal Government are expected to rise to almost $210 billion in the current fiscal year. If the growth in total funds raised in domestic credit markets during 1982 matches the average growth of the past 5 years, total funds raised under Federal auspices will account for about 45 percent of the total funds raised in U. S. credit markets. This is up sharply from the 35 percent absorption rate registered in fiscal year 1981. (See exhibit, p. 166.)

The prospect of huge Federal credit demands together with the restrictive stance of the Federal Reserve has depressed financial markets, boosted short-term borrowing costs, and kept long-term interest rates at record levels. The recent run-up in market interest rates and the possibility of the trend continuing in the future are undercutting the changes for a vigorous economic recovery and undermining the President's economic revitalization program. Moreover, the administration's goal to shift resources from public to private use may be frustrated by the squeeze that excessive Federal credit demands are putting on private credit flows. Any such crowding out of private financing, of course, depends on the extent to which the economy's resources and credit markets are being utilized. During past recessions, for example, large Federal credit demands could be easily handled by the credit markets. In these instances, Federal credit activity increased aggregate demand, and thereby promoted a more intensive use of our Nation's resources rather than a rise in interest rates and a consequent shift in resource use from the private to the public sector. During these periods, crowding out was not an impediment to private capital formation. However, if in the recovery period ahead, Federal credit demands remain high and if the Federal Reserve maintains a tight credit policy, interest rates will rise and loanable funds will shift away from private producers and into public sector activities.

Such crowding out in my opinion, is contrary to the spirit of the 1981 Tax Act in that it largely offsets the act's investment incentives by placing upward pressure on interest rates and the cost of capital. Thus, the current mix of easy fiscal policy and tight monetary policy is likely to have an adverse effect on the health of the U.S. economy and our longrun ability to compete in foreign markets.

EFFORTS MADE TO CONTAIN GROWTH OF FEDERAL CREDIT

To avoid this gloomy outcome, both the Congress and the administration should make every effort to hold down the growth of Federal expenditures and to seek out new sources of revenue that do not interfere with saving and investment incentives. In addition, every effort should be made to control the scope and size of Federal credit programs. In this regard, Congress is to be commended for its past efforts to contain the growth of Federal credit. Noteworthy past efforts include:

The adoption by Congress and the administration of an informal credit budget that complements the unified budget and enhances control over Federal credit activities.

The inclusion of credit targets and limits in the budget resolution in order to focus attention on the level and scope of Federal credit programs and to control their activities.

The establishment of data systems to monitor legislative action on credit programs.

And, the development of an automated scorekeeping process to compare congressional action on credit bills against the targets established in the budget resolution.

These efforts are a good beginning but much more clearly needs to be done if we are to control these programs. In this regard, I recommend that the informal credit targets now in existence should be made binding and that any legislation violating the credit limits should be made subject to a point of order. In addition, the quantity of Federal credit could be controlled more effectively by requiring appropriations action for all credit programs. However, any changes in present targeting or legislative procedures should be approached carefully so as to avoid damaging the effectiveness of our emergency assistance and entitlement programs. The current credit budget—quite rightly—exempts many of these programs from the credit ceilings, but this exemption should not prevent the establishment of formal criteria to evaluate the legitimacy of emergency programs. Such criteria also could be used to ward off any attempt to circumvent the controls imposed by the credit targets.

Another area that needs to be more closely monitored and controlled is the activity of the Federal Financing Bank. By purchasing loans and certificates of beneficial ownership from onbudget agencies, the FFB transfers loans from onbudget to offbudget status. Even though the Treasury's total borrowing requirements do not change by these transactions, the unified budget is distorted and the normal onbudget review process of credit agency activity is undermined.

The Congressional Budget Office recently offered some recommendations to reform the budgetary treatment of the FFB. The proposals included both the abolition of the FFB, and the complete restructuring of the unified and the credit budget. Abolishing the FFB clearly is too extreme. A return to uncoordinated agency borrowing would undermine Treasury debt management policies, create serious marketing problems, and increase the expense of financing Government programs. The other approach—to restructure the Government's accounts by placing all net direct lending on and offbudget and all net guaranteed loans into a separate credit budget—has more appeal. This reform would nullify the FFB as a vehicle for transferring loans from on to offbudget status. It also would establish two different deficits—one for spending and one for lending—that would explicitly recognize the Federal Government's impact on resource use and on credit allocation.

The credit scorekeeping activities of Congress and the Congressional Budget Office also need to be supported and extended. A comprehensive scorekeeping system is essential if Congress is to be provided with data comparing legislative action on credit bills with the functional credit targets, and with up-to-date reports and reestimates of Federal credit activities.

Ideally, the combined effects of credit scorekeeping, binding credit limits, and a restructured budget should provide Congress with the framework and the information needed to make meaningful decisions on the costs and benefits of alternative expenditure and credit programs. By forcing competitive tradeoffs, these reforms should improve the efficiency of the Federal Government's overall credit efforts and should increase congressional appreciation of the Federal Government's intervention in the real and financial marketplace.

In sum, both the administration and Congress have made considerable progress in their efforts to monitor and control Federal credit activities. But given the huge size of the Federal Government's future borrowing requirements, much more needs to be done. Credit targets must be made binding and Congress must evaluate each and every program to determine which ones have outlived their usefulness. Congress also must establish monitoring mechanisms to insure that the targets are hit. Unless the growth of Federal credit demand is controlled, the fruits of the economic revitalization program that we all desire will continue to elude our grasp. Mr. Chairman and members of the committee, further action in this area is clearly and urgently needed.

That concludes my statement, Mr. Chairman.

Senator GORTON. Thank you, Dr. Fralick.

PREPARED STATEMENT OF JAMES S. FRALICK, VICE PRESIDENT, ECONOMIC ANALYSIS DEPARTMENT, MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. Chairman and Members of the Committee:

I very much appreciate this opportunity to discuss the importance of improving the budgetary treatment and control of federal credit activities.

The release of the Administration's fiscal year 1983 budget, on February 6, makes this particularly appropriate time to consider budgetary procedures for the control of federal credit programs. The large unified budget deficits now projected for fiscal years 1982, 1983, and 1984 have made financial markets increasingly anxious as they contemplate a huge rise in Treasury offerings from $79 billion last year to almost $120 billion in the current fiscal year.

Compounding this problem is the continued rise in the activities of federal credit programs. When net guaranteed loans and net sponsored-enterprise borrowing are added to the Treasury offerings mentioned above, the total credit needs of the federal government rise to $209.6 billion in the current fiscal year from $142.1 billion in fiscal year 1981. If the growth in total funds raised in domestic credit markets during 1982 matches the average growth of the past two years, total funds raised under federal auspices will account for 45% of the total funds raised in U.S. credit markets -- up sharply from the 35% absorption rate registered in fiscal year 1981. (See exhibit.)

The prospect of huge federal credit demands together with the restrictive stance of the Federal Reserve has depressed financial markets, boosted short term borrowing costs, and kept long-term interest rates at record levels. The recent run-up in market interest rates and the possibility of the trend continuing in the future are undercutting the chances for a vigorous economic recovery and undermining the

President's economic revitalization program. Moreover, the Administration's laudable intent to divert resources from public or private use may be frustrated by the squeeze that excessive credit demands put on private credit flows -- the "crowding out" effects that have been frequently cited in recent years. Any such displacement of private financing, of course, depends on the extent to which the economy's resources are being utilized, and on conditions in credit markets. During past periods of economic slack, for example, large federal credit demands could be easily absorbed by credit markets. In these instances, federal credit activity increased aggregate demand, and thereby promoted a more intensive use of our nation's resources rather than a rise in interest rates and a consequent shift in resource use from the private to the public sector. Under these circumstances, crowding out would not have been a significant impediment to private investment. However, if federal credit demands remained high during the period of recovery and expansion and if the Federal Reserve maintained a tight credit policy, interest rates would have risen and loanable funds would have shifted away from private producers and into public sector activities. This has apparently been the case in recent years.

As the U.S. economy recovers from the current recession, it is increasingly likely that Federal borrowing and credit activities will clash with the Federal Reserve's restrictive targets and thus will crowd private borrowers from the market. Such displacement in my opinion, is contrary to the spirit of the Tax Act of 1981 in that it largely offsets the Act's investment incentives by placing upward pressure on interest rates. As a consequence, the cost of of acquiring new capital for corporations may not be significantly reduced. A mix of easy fiscal policy and tight monetary policy thus is likely to have an adverse effect on the health of the U.S. economy and our long run ability to compete in foreign markets.

To avoid this gloomy outcome, both the Congress and the Administration should make every effort to scrutinize and control the scope and size of federal credit programs. In this regard, Congress is to be commended for its past efforts to contain the growth of federal credit. Noteworthy past efforts include:

- Adoption by Congress and the Administration of an informal credit budget that complements the unified budget and enhances control over federal credit activities.
- Inclusion of credit targets and limits in the budget resolution in order to focus attention on the level and scope of federal credit programs and to control their activities.
- Establishment by the Budget Committees and the Congressional Budget Office of systems to monitor legislative action on credit programs.
- Development of an automated scorekeeping process to compare Congressional action on credit bills against the targets established in the budget resolution.

These efforts are a good beginning but much more clearly needs to be done if we are effectively to control these programs. In this regard, the informal credit targets now in existence should be made binding and any legislation that violates the credit budget limits should be made subject to a point of order. In addition, the quantity of federal credit could be controlled more effectively by requiring appropriations action for all credit programs. However, any changes in present targeting or legislative procedures should be approached carefully so as to avoid damaging the effectiveness of emergency assistance and entitlement programs. The current credit budget -- quite rightly -- exempts many of these programs from the credit ceilings, but this exemption should not prevent the establishment of formal criteria to evaluate the legitimacy of emergency programs. Such criteria also could be used to ward off any attempt to create "psuedo emergency programs," whose only purpose is to avoid the control imposed by the credit targets.

Another area that needs to be more closely monitored and controlled is the activity of the Federal Financing Bank. By purchasing loans and certificates of beneficial ownership from on-budget agencies, the FFB transfers loans from on budget to off budget status. Even though the Treasury's total borrowing requirements do not change by these transactions, the unified budget is distorted and the normal on-budget review process of credit agency activity is undermined.

The Congressional Budget Office recently offered some recommendations to reform the budgetary treatment of the FFB. The proposals included both the abolition of the FFB, and the complete restructing of the unified and credit budgets. Abolishing the FFB clearly is too extreme. A return to uncoordinated agency borrowing would undermine Treasury debt management policies, create serious marketing problems and increase the expense of financing government programs. The other approach -- to restructure the government's accounts by placing all net direct lending (on and off budget) and all net guaranteed loans into a separate credit budget -- has more appeal. This reform would nullify the FFB as a vehicle for transferring loans from on to off-budget status. It also would establish two distinct deficits -- one for spending and one for lending -- that would explicitly recognize the federal government's impact on resource use and credit allocation.

Finally, the credit scorekeeping activities of Congress and the Congressional Budget Office need to be supported and extended. A comprehensive scorekeeping system is essential if Congress is to be provided with data comparing legislative action on credit bills with the functional credit targets, and with up to date reports and re-estimates of federal credit activities.

Ideally, the combined effects of credit scorekeeping, binding credit limits, and a restructured budget should provide Congress with the framework and the information needed to make meaningful decisions on the costs and benefits of alternative expenditure and credit programs. By forcing competitive trade-offs, these reforms should improve the efficiency of the federal government's over-all credit efforts and should increase Congressional appreciation of the federal government's intervention in the real and financial market place.

In sum, both the Administration and Congress have made considerable progress in their efforts to monitor and control federal credit activities. But given the huge size of the federal government's future borrowing requirements, much more needs to be done. Credit targets must be made binding and Congress must evaluate each and every program to determine which ones have outlived their usefulness. Congress also must establish monitoring mechanisms to insure that the targets are hit. Unless the growth of federal credit demand is controlled, the fruits of the economic revitalization that we all desire will continue to elude our grasp. Mr. Chairman and members of the committee, further action in this area is clearly and urgently needed.

Thank you again for giving me the opportunity to express my views.

BORROWING UNDER FEDERAL AUSPICES:
ABSORPTION OF DOMESTIC CREDIT MARKET FUNDS
(Fiscal years; in billions of dollars)

	Five-Year Averages							
	1955-1959	1960-1964	1965-1969	1970-1974	1975-1979	1980	1981	1982
Total funds raised in domestic credit markets[1/]	35.5	50.8	80.6	148.6	301.7	342.5*	407.8	453.0e
Federal borrowing	2.1	4.5	6.4	13.0	56.8	70.5	79.3	115.4
Net guaranteed loans	4.0	4.3	5.1	13.9	13.6	31.6	28.0	44.0
Net Government-sponsored enterprise borrowing	0.4	0.7	1.0	5.0	12.6	21.4	34.8	46.6
Total funds raised under Federal auspices	6.5	9.5	12.4	31.9	83.0	123.5	142.1	206.0
Federal absorption rate	18%	19%	15%	21%	28%	36%	35%	45%e

1/Funds raised by non-financial sectors, excluding equities. Source: Federal Reserve Board Flow of Fund Accounts, adjusted during 1955-69 for consistency with budget concepts.

*Source: Office of Management and Budget.

[e] Morgan Guaranty estimate.

TAXES THAT EXCLUDE SAVINGS AND INVESTMENTS

Senator **Gorton**. Dr. Fralick, I followed the text as you went through the text of your statement here. You added something to that text, and I propose to ask you about it. You added that comment on the direct Federal budget deficit necessity for spending controls. I think you said something to the effect of new sources of revenue which do not impair economic growth. Did I catch you correctly?

Dr. **Fralick**. Yes; I said that Congress should "seek out new sources of revenue that do not interfere with savings and investment incentives."

Senator **Gorton**. Why do you not tell me what kind of revenues you are talking about?

Dr. **Fralick**. Mr. Chairman, the revenue sources that I am talking about are basically taxes that would exclude saving and investment. By this, I mean consumption or sales taxes. I think a number of studies recently have been published that have shown that taxation drives a wedge between a rate of return on savings, and the market rate of interest. As a result present consumption is encouraged and saving is discouraged. Consumption taxes, by excluding saving, and the return on saving, do not drive a wedge between the rate of return and the rate of interest. Under these circumstances, the incentive to save would be enhanced.

Senator **Gorton**. You feel that the President made a mistake then by not recommending increases in the number of excise taxes?

Dr. **Fralick**. Given the size of the budget deficits that we are faced with—certainly over $100 billion in 1983, and possibly 1984—I believe that Congress should take a close look at the revenue side of the budget as an avenue for solving this problem.

ADOPT CREDIT BUDGET WITH BINDING TARGETS

Senator **Gorton**. Thank you. That was outside your formal statement and therefore outside my direct questions, but I appreciate your including it.

We hear discussions every single day of the week here about Wall Street's perception of the will of Congress and of the administration, to control fiscal activities. Do you think the adoption of a formal credit budget to gain control of Federal credit activities would send a strong signal to the financial community that Congress is meeting the challenges that are implicit in our present budgetary situation, or is there as much lack of knowledge on your street as there is here?

Dr. **Fralick**. I think, Mr. Chairman, if Congress were to impose a credit budget, and were to make those targets binding, this would send a signal. However, I think a stronger signal would result if the markets saw those targets and limits actually being achieved. I believe that it is crucial that any overruns be avoided and that the targets be hit. Too often in the last few years, every budget that is submitted has experienced substantial overruns in the initial deficit estimate. I think the same thing has been true in the Federal credit budget.

So I believe that a strong message could be sent to the financial markets if the credit budget were to be controlled and the targets hit.

HIGHER DEFICITS PROJECTED

Senator **Gorton**. Thank you. I understand that the Wall Street Journal today says that you believe that the deficit for fiscal 1983 and thereafter is going to be higher than the administration's projections. Do you base that perception on what you consider to be inaccurate projections of the activities of the economy or because you believe that the proposals in the President's budget will not be acceptable?

Dr. **Fralick**. The former, Mr. Chairman.

I simply took the President's totals and adjusted them for our economic assumptions.

Senator **Gorton**. How much higher deficit did that produce?

Dr. **Fralick**. I had a range of $120 billion to a $140 billion for fiscal 1983, and $140 billion to $160 billion for fiscal 1984.

Senator **Gorton**. Do you agree with Dr. Greenspan that present interest rates indicate that the market has already anticipated deficits of that nature?

Dr. **Fralick**. I think there was an upward, movement in December, as Dr. Greenspan indicated. However, it is very difficult to disentangle how much of the upward movement was due to the leak of the administration's revised deficit projections, or due to the increase in the monetary aggregate that began to occur in late November and early December.

But from my perspective, there was a shock. Most individuals on Wall Street held out hope that the President would be able to hold the deficit down in fiscal 1983 and 1984. Once those numbers leaked, some disenchantment began to set in.

Senator GORTON. I take it that these perceptions that you have given us today are not unknown but commonly held?

Dr. FRALICK. That is right. In terms of 1984, however, the deficit estimates that appeared in today's Wall Streed Journal may have been on the high side.

IMPACT OF LOWER DEFICITS ON INTEREST RATES

Senator GORTON. Given that perception, if we were to produce a budget which had deficits no higher than the present, or for that matter we are willing to even further to reduce them substantially, what kinds of impact over what period of time do you propose that that would have.

Dr. FRALICK. Impact on what?

Senator GORTON. On interest rates.

Dr. FRALICK. I believe that it would have a favorable impact on interest rates. I think the markets at this time are concerned about the tremendous supply of Treasury offerings coming to market and the potential borrowing needs on the private sector. Faced with this supply problem, the markets worry about their ability to digest the prospective offerings.

Senator GORTON. What is the relative nature of that positive impact, depending on the mix, in which we reduce that budget deficit as reducing spending and increasing revenues?

Dr. FRALICK. That is a difficult question. I think the financial markets would like to see reductions in expenditures, but many people realize that the United States needs adequate spending for defense, for human capital, for our social infrastructure. Many people believe that spending on these last two items is needed if we are to ever use our domestic productivity.

I also heard some people express some willingness to tolerate some tax increases because they believe that we have to pay for some of these social goods.

Senator GORTON. Now, a more specific question on what you gave in your testimony. Government-sponsored enterprises, such as the Federal National Mortgage Association which borrow in the private market are not backed by the full faith and credit of the Federal Government. It is often asserted, however, that the financial markets perceive Government-sponsored enterprises as full faith and credit borrowers. Is this true?

Dr. FRALICK. I believe that it is true.

ONE CREDIT MARKET POSSIBLY TIED TO FEDERAL FUND RATE

Senator GORTON. There is some discussion of the proposition that there is not a single credit market but several distinct segments of loanable funds which do not have a great deal of flow between them. For example, funds available for long-term debt will not flow to market for short-term commercial borrowing. Is that true.

Dr. FRALICK. I think there is one credit market, and this credit market, from my perspective, seems to be very much tied to the

Federal funds rate. Changes in the Federal funds rate typically spill over into changes in all other rates. So it seems to me that there is only one market.

RELATIONSHIP OF FEDERAL CREDIT TO DOMESTIC CREDIT MARKETS

Senator GORTON. Finally, a lot of discussion of Federal credit is in the context of its relationship to exclusively domestic credit markets. The Eurodollar market, however, is growing, apparently since the supply of credit from American borrowers and foreign investment seems to ebb and flow about now with your investment rates. Is it appropriate to limit the credit to U.S. markets alone?

Dr. FRALICK. I do not think so.

I am not an expert in the Eurodollar market but the flow of funds between the United States and Europe and Japan is something that needs to be considered more fully. These credit flows certainly helped finance the U.S. deficit in fiscal 1980 and 1981. The question is now whether this source of funds can be tapped in the future in order to take some of the pressures off the domestic credit market.

Senator GORTON. Unfortunately, just as we managed to lower interest rates here in the United States, we will to a certain extent dry up that source of credit.

Dr. FRALICK. Exactly. I think that this is an important area. It is worthy of further research and one should encourage the CBO to look at.

Senator GORTON. Doctor, you have sat through a long afternoon to help us out here today, and I should like to tell you that the committee gratefully appreciates your careful and objective analysis. We hope that we will be able to say a few months down the road that you had an impact on what we do.

Dr. FRALICK. Thank you, Mr. Chairman.

[Whereupon, at 4:37 p.m., the hearing was adjourned.]

OVERVIEW OF FEDERAL CREDIT

THURSDAY, FEBRUARY 11, 1982

U.S. Senate,
Temporary Task Force on Federal Credit,
Committee on the Budget,
Washington, D.C.

The task force met at 2:10 p.m., in room 6202, Dirksen Senate Office Building, Hon. Slade Gorton presiding.

Present: Senator Gorton.

Staff present: Stephen Bell, staff director; David Nummy, special assistant to the staff director; Lizabeth Tankersley, minority staff director; and Ann Hadley, analyst for credit budget.

OPENING STATEMENT OF SENATOR GORTON

Senator Gorton. I would like to welcome the witnesses to this third hearing of the Senate Budget Committee's Task Force on Federal Credit. The requirement of the Budget Act that our committee should study and report to Congress methods to improve the budget process has resulted in the formation of this task force. We have been asked to examine the ever-increasing problem of Federal intrusion in the credit markets through its direct borrowing to finance the on- and off-budget deficit and through the over 150 loan guarantee programs conducted by the Federal Government.

Substantial evidence has been given to this task force to indicate that the participation of the Federal Government in the credit markets results in higher interest rates, which "prices out" other unassisted borrowers. This year, Federal borrowing to finance the on- and off-budget deficit is expected to be $115 billion, borrowing with a Federal guarantee is expected to be $44 billion, and borrowing by Government sponsored enterprises is expected to total $46.6 billion. The sum of these three components of federally related borrowing is $206 billion, over 40 percent of the expected amount of total credit available.

CLOSE SCRUTINY REQUIRED

I believe that many credit assistance programs serve worthy purposes. But I also believe that this level of intrusion in our Nation's credit markets requires the closest scrutiny by Congress with the full knowledge of what we are doing and exactly what we are imposing on the economy. The current budgetary treatment of these programs makes it difficult to review and assess these very questions. It has been asserted before this task force that the ability to place much of Federal credit activity outside the budget is one of the reasons for the tremendous expansion of these programs in recent years.

In addressing the issue of credit, our task force is looking at the prospects of recommending to the full committee a more comprehensive and enforceable credit budget beyond what we currently include in the budget resolutions. Some Members of Congress, such as Senator Percy, have introduced legislation establishing a formal credit budget. We will look at such legislation in a hearing in March. Nonetheless, we would welcome any comments that you might have on this topic.

I look forward to hearing the thoughts of our witnesses here today. I would ask that opening statements be summarized to 5 to 10 minutes. Prepared statements will be made part of the record.

Our first panel will consist of Dr. Utt, Mr. Huard, and Mr. Motley. And if those three gentlemen will come forward, we will proceed.

We have received a statement from Senator Tower, who is unable to be here this afternoon. Without objection, we will insert it into the record at this point.

STATEMENT OF SENATOR JOHN TOWER, U.S. SENATOR FROM THE STATE OF TEXAS

Mr. Chairman, let me turn to a program that I believe should be exempt from the Administration's general reduction in federal loan guarantees—and that is the Title XI vessel loan guarantee program of the U.S. Maritime Administration. I have written to Mr. Stockman on this issue, but we remain considerably far apart.

First, let me say that I agree with the general thrust of the Administration's effort, however, this program is tremendously important to our overall national security interest and suffers from little or none of the problems that have rightfully highlighted loan guarantee programs in general to the OMB budget reduction efforts.

Shipbuilding is a unique enterprise, especially given the way we finance large capital items in this country. First, it requires longer-term financing than is generally permitted by our understandably cautious credit institutions. Secondly, the finished product represents a larger, more mobile asset than these service institutions normally handle as collateral. If a default occurs, they are naturally concerned about where the asset would be at the time and how to recoup their investment.

To overcome this, the Title XI program was born, and its purpose and especially its history set it apart.

First, it provides the guarantee that permit the long-term financing necessary to build ships.

Second, it assesses a user charge which covers the cost to administer the program.

Third, it is an off-budget item and requires no appropriated funds.

Fourth, it is not a subsidy.

Fifth, not only have the overhead costs been paid by the user fees, but the few losses to date have also been paid for, either from asset resale or from the fees themselves.

Finally, the Title XI guaranteed borrowing represents 1/400 of total direct and assisted borrowing by the Federal Government, and thus has only a negligible impact on the credit market.

Thus, while its reduction will have a dramatic effect on our vital maritime assets, it would do little to alleviate pressures on the credit market as claimed by the budget director. Moreover, the budget director claims that this decreasing pressure would thereby facilitate private sector financing at lower interest rates. As I mentioned above, this program came about not because of differing interest rates between private and public sectors, but because the private sector could not institutionally handle loans of this magnitude. Again, reduction of the program will have a deleterious effect on our vital merchant marine assets, and will do nothing to help facilitate needed loans.

Mr. Chairman, I understand that the scope of these hearings involves a broader analysis of the effects of federal loan guarantees on our credit market. I did, however, want to express my abiding concern with regard to any deduction in a program so vital to our national security.

Senator GORTON. Dr. Utt, we have you listed first so you can start, if you will.

STATEMENT OF RONALD D. UTT, ASSOCIATE CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Dr. UTT. Thank you, Senator.

I am Dr. Ronald D. Utt, associate chief economist for the U.S. Chamber of Commerce, on whose behalf I am testifying today. I would like to commend the Budget Committee for establishing the task force to investigate this important but often neglected aspect of Federal credit allocation and market intrusion.

Given the limited time available for my presentation, I will dispense with a discussion of the many problems associated with the rapid growth of these programs and confine my remarks to the chamber's recommendations for improving the management and control over this vast array of programs.

The scope and impact of the problem is reviewed in my written statement and has been adequately covered by many of the witnesses that have already addressed this task force.

Following a careful consideration and review of these programs, their budgetary implications, and the many factors that have influenced their growth, the chamber recommends the enactment and/or development of four key proposals that we believe would make an important contribution to reforming the Federal loan programs and limiting their future growth.

ENACT MINETA-BETHUNE AND PERCY BILLS

First, we recommend the swift enactment of the proposals embodied in the Mineta-Bethune and Percy bills. The establishment of a formal credit budget and the systematic application of the procedures of the congressional budget process to these credit programs would be an important first step in the direction of improving congressional control over Federal loan support activities.

Under such a system, Congress would be encouraged to set an overall credit target consistent with macroeconomic objectives, trends in the budget deficit, and the state of the domestic financial markets.

Once this upper limit is established, Congress would then be required to allocate this total among competing uses in a way that was consistent with current national objectives. Such an allocative process would, hopefully, induce a closer scrutiny of each program. In turn, this scrutiny could contribute to long overdue program reforms and the elimination of those programs that have outlived their usefulness.

DEVELOP CLEAR AND CONCISE CRITERIA

In order to facilitate this evaluative process, our second recommendation is that this task force develop a clear and concise criteria that could be used to reassess each of the existing proqrams and to better relate the objectives of the program with the type of credit assistance that is offered.

In surveying the 350 some odd credit programs, it is obvious that they represent a 50-year accumulation of overlapping activities without any clear sense of priorities regarding either the level of support, the depth of support, or the type of support.

Interest rate subsidies vary widely and appear to have little relationship to pressing national objectives. This criteria should assist us in answering questions such as: What are the beneficiaries' credit problems—access or ability to pay? Is the existing interest rate subsidy appropriate in light of changed financial conditions? Are the programs equitable? Has the original program objective been met? Where an interest rate subsidy was once offered, will a guarantee be sufficient now?

Given the vast scope and complexity of the Government's credit market involvement, such a criteria will be essential to making informed decisions on the needs for existing and proposed programs.

LIMIT INTEREST RATE SUBSIDIES

Our third recommendation is to limit the interest rate subsidies on direct loans and loan guarantees that are converted into direct loans. Many interest rates were set by statute in the distant past when market rates were much lower. Programs that once offered modest subsidies now provide deep ones. The failure to change these rates in response to changed market conditions has contributed both to rising program costs and excessive program demand.

ELIMINATE PROGRAMS THAT CAN BE MET BY PRIVATE SECTOR

Finally, we urge that, in reviewing the existing programs, this task force consider for modification, reduction, or elimination, those program objectives that can now be met by private sector sources. Many Federal programs have provided important benefits to our economy by either demonstrating the commercial viability of a certain type of loan or enterprise, or by providing credit for important segments of our economy when financial and economic stress immobilized the private financial system. But, as times change, the initial justification for establishing the program may no longer exist.

In conclusion, the chamber believes that these programs would make an important contribution to limiting the growth in Federal credit programs. We urge the task force to carefully consider these proposals, and recommend that Congress enact the appropriate legislation to put them in place.

Thank you.

Senator GORTON. Thank you, Dr. Utt.

PREPARED STATEMENT OF RONALD D. UTT, ASSOCIATE CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

I am Dr. Ronald D. Utt, Associate Chief Economist for Economic Policy at the Chamber of Commerce of the United States. On behalf of the Chamber's over 218,000 business, trade association and local and state chamber members, I welcome this opportunity to present our views on the general issues involved in the recent rapid growth of the vast array of federal loan and loan guarantee activities.

Over the past several years, these federal loan programs have expanded at a rate in excess of the direct federal spending programs. As a consequence, federal credit program activity has risen to record levels of intrusion in U.S. financial markets, leading to an unprecedented degree of government credit allocation.

Given the current state of our financial markets, the expectation of continued large budget deficits and the private sector's need for investment capital, this Task Force is to be commended for focusing its attention on this often ignored aspect of federal credit market intrusion.

Typically, concern for the extent to which the federal government "crowds out" private borrowers has been expressed solely in terms of the size of the budget deficit. The deficit does, of course, interfere with financial markets, but it is only one aspect of the full measure of federal credit pre-emption because it does not reflect the activities of the loan and loan guarantee programs of federal agencies and federally-sponsored enterprises. Indeed, in the last two fiscal years, these programs pre-empted an even greater share of domestic credit resources than did the deficit.

Scope of the Federal Credit Control Problem

Defined as direct loans and loan guarantees from federal agencies and federally-sponsored entities, these lending programs have exhibited all of the growth and control problems usually attributed to federal spending. In recent years, these loans and loan guarantees have grown at a much faster rate than has the more widely considered measure of budget outlays. From 1976 to 1980, outlays rose 58% compared to 80% for outstanding federal loans and loan guarantees.

Compared to the attention devoted to the deficit, the relative neglect of this lending activity is rather surprising inasmuch as these programs have essentially the same effect on our economy and its financial markets as does the more visible deficit. Both lay claim to scarce domestic resources and reallocate them to a vast array of beneficiaries. Moreover, these programs are not negligible in size. During FY 1980, the federal government and its sponsored enterprises made $148 billion in loans to various private and quasi-private entities, and guaranteed another $69.8 billion in loans, for a total of $217.8 billion in federal credit market intervention. After netting out repayments and double counting, net new lending and guarantee support reached $79.9 billion in FY 1980 and $86.5 billion in FY 1981, amounts one-third greater than the budget deficits for those fiscal years.

As a result of the recent rapid growth in these programs, federal lending support in 1980 and 1981 accounted for 23.3% and 21.2%, respectively, of total funds advanced in U.S. credit markets, up from 17.8% in FY 1979 and 11.9% in FY 1977. When the borrowing needed to fund the deficit is added to this, total government credit demands amounted to 35.7% of all funds raised in U. S. credit markets during FY 1980.

In large part, the size of the lending activity and the rapid growth of the programs are attributable to the special attractiveness of these programs to the eligible borrowers and the government officials who create, enact and administer them. The borrowers like the programs because they offer loans at interest rates that are often substantially below market rates, with rates of 2%, 5% or 7% not uncommon. The Office of Management and Budget estimates that the present value of the interest rate subsidies available on federal loans made during FY 1980 amounted to $18.8 billion.

Public officials like the programs because they offer a way of assisting constituent groups without adding to budget outlays and the reported deficit. Moreover, the funding of these programs does not necessarily require any increase in tax revenues. Of the $86.5 billion of net new loan support provided in FY 1981, only $5.2 billion appeared on the budget. The remainder stayed off budget, either through a variety of creative accounting techniques or because the program's authorizing legislation specifically stated that the program will not be included in the budget. The Federal Financing Bank (FFB), a major source of funding for many of the loan programs, is off budget by statute. By the end of FY 1981, the FFB's holdings of agency debt totalled $107 billion.

The practice of giving these loan programs an off budget status has contributed to their rapid growth by removing them from the close scrutiny of the budget process and from the view of a public that has become increasingly concerned about the deficit as reported by present federal accounting procedures.

The growth of these programs and the apparent lack of a mechanism or the will to control them is particularly alarming in light of this country's widely-acknowledged capital formation problem and the effect this has on our productivity, standard of living and international competitiveness. Given this concern for investment, it is unfortunate that the continued neglect of these lending programs has allowed them to grow to the point where they now pose a threat to capital formation.

Since private business capital formation depends heavily upon the cost and availability of credit, public policies that raise costs and/or limit supply will diminish the amount of private capital formation that is undertaken. These credit programs, by pre-empting a growing portion of the credit pool, reduce the amount of funds available to the private business sector as well as to the consumer who must compete with the government for credit to purchase a home or an automobile.

Further, the interest rate subsidies that usually come with these federal loans contribute to an inefficient allocation of credit within our economy. At a time when high interest rates force businesses to limit their investment and to direct their funds only to those projects that offer the promise of very high yields, federally-assisted borrowers, paying subsidized interest rates, are able to invest in projects whose return may be only a third or a fourth of that required by private business. As a consequence, the productivity of our capital stock is lowered and economic growth and output suffer accordingly.

In addition to their adverse impact upon the Nation's efficient use of its scarce capital resources, the operation of these lending programs has often been wholly out of phase with major macroeconomic policy initiatives. During 1980, efforts to reduce the rate of inflation were the primary focus of government policies, and heavy reliance was placed upon the Federal Reserve to meet that objective by slowing the growth of overall credit extensions. As the record clearly shows, the Fed was successful in achieving that objective. The amount of total credit advanced in the U.S. economy actually fell by 17.3% from FY 1979 to FY 1980. The present depressed state of our housing and auto industries and the decline in business fixed investment attest to the impact of this policy.

But while the private sector was forced to make do with less, the federal lending programs and the recipients of their many loans and loan guarantees not only remained unscathed but managed to increase their share of the credit pie by a substantial amount. In fact, the net volume of credit advanced under federal auspices actually increased over the period. Thus, while one segment of government was taking harsh measures to reduce inflation, the actions of other government agencies offset these efforts. As a result, the unassisted sector bore a disproportionate burden of monetary restraint. In 1980, when a 20% prime rate and 16% consumer loan rate contributed to the failure of approximately 1,600 automobile dealerships, the Rural Electrification Administration began a new program to provide 35 year loans at a 5% interest rate to finance rural cable television systems.

Recent Efforts to Control Federal Credit

In recent years, there has evolved in public policy circles an increased awareness of the problems created by the rapid growth in these programs. This recognition of the problem has led to the development of a number of proposals designed to exert some sort of control over federal lending. Former President Carter's 1980 budget expressed concern over this growth and announced the implementation of a control system based on annual limitations on gross lending activities. In his 1981 budget, a credit budget was introduced and loan and loan guarantee targets were set for the next fiscal year. In order to offset the excessive growth in the past, the President's budget for that year proposed that direct loan obligations should increase by only 1.7% and that growth in loan guarantees should be held to 8.3%. But by the time his 1982 budget was published, it was apparent that the new control system was slipping badly and that 1981 federal credit growth would greatly exceed the targeted rates. The 1.7% growth rate for direct loans had reached 21% while guaranteed loans, targeted to grow at 8.3, were estimated to rise by 31%.

Similar concerns arose in Congress and more effective remedies have been proposed. Recognizing that the ubiquitous budgetary status of many of these programs was partly to blame for their apparent uncontrollability, Reps. Mineta and Bethune and Senator Percy have introduced legislation (H.R. 2372 and S. 265) that would have the effect of formally including all federal credit activities, regardless of current budget status, in the congressional budget process. Under their proposals, Congress would create a credit budget that would establish formal limits on total federal lending support for each fiscal year. In effect, Congress would follow the same budget process for loans and guarantees as is currently mandated for revenues and spending. With the total established at the outset, Congress would have to allocate this fixed amount among competing federal programs according to a clearer sense of national priorities. The Chamber has endorsed these two bills and recommends their swift enactment.

In his budget proposals of March, 1981, and February, 1982, President Reagan proposed substantial reductions in loan and loan guarantee authorizations for many of the credit programs, as well as numerous changes in borrower eligibility and interest rate subsidies. The Chamber endorsed these proposals in 1981 and currently has the FY 1983 proposals under consideration.

Chamber Recommendations to Control Federal Credit

While a committed President and Congress can work together to limit federal lending growth during a given budget year, it is imperative that a more permanent and comprehensive process be adopted to ensure that these programs come under scrutiny every year and that firm limits, consistent with macroeconomic stabilization objectives and long-term economic growth goals, are set on overall lending growth.

As trends over the past several years demonstrate, informal targets and good intentions are not always sufficient to restrain these programs in the face of substantial demand for subsidized loans. A more formal and binding process is required if we are to restore a balance between private and public credit needs.

It is for this reason that the U.S. Chamber strongly endorses the proposed changes to the Budget Control and Impoundment Act of 1974 that are contained in H. R. 2372 and S. 265.

By establishing a formal credit budget and bringing all credit programs within the discipline of the budget process, these legislative proposals represent an important first step in controlling the growth of federal credit activities. For the first time, Congress would have to set an overall credit target consistent with general macroeconomic objectives, trends in the budget deficit and the state of the domestic financial markets. This process could also be used to gradually lower federal credit intrusion in domestic credit markets to the 14% it averaged during the decade of the 1970's.

Once such an upper limit is established, Congress would then be required to allocate this fixed total among competing uses. This would necessitate scrutiny of each of the many loan support programs. In turn, this evaluative process could lead to program reforms, as well as the elimination of duplicative programs and those that have outlived their usefulness.

In addition to our support for the proposed amendments to the Budget Control Act, the Chamber also recommmends that Congress consider the development and/or enactment of the following proposals.

Establish Criteria for Granting Federal Credit Support

In order to evaluate effectively the extensive collection of federal credit programs it is imperative that Congress have a clear and concise criteria to apply to each program when considering whether the program should be continued as is, reformed, reduced or eliminated. Given the different basic forms of credit support that are offered and the many different reasons why programs have been established, such a criteria would be a valuable tool for reforming the credit programs and establishing better control over their growth.

As a starting point, I would observe that credit programs have been established for three basic reasons:

(a) To overcome imperfections in credit markets. Such imperfections include inadequate private credit facilities and/or an overestimation of loan risk by private lenders.

(b) To overcome a divergence between an investment's private and social returns. In some cases, a project may have important benefits to society while yielding only modest returns to a private investor.

(c) To compensate for the inadequate incomes of potential loan recipients. Individuals or communities with low to moderate incomes may be denied access to needed credit because of an inability to carry the debt service changes at market interest rates.

In the case of (a), loan guarantees or direct loans at market interest rates would be the appropriate form of federal credit assistance. In the case of (b) and (c), some form of interest rate subsidy may be offered in conjunction with either a direct loan or loan guarantee.

The categorization of programs by the above criteria or some similar set of objectives would be a useful starting point for evaluating the government's diverse credit activities. Once this is done, programs within catetories could be more easily compared and subsidies better evaluated.

Limit the Interest Rate Subsidies Available on Direct Loan Programs

A review of Table F-11 of Special Analysis F of the budget indicates that the interest rate subsidies on some programs are quite deep and that the dollar costs of these subsidies are quite expensive in terms of present and future budget outlays. In the case of many of these programs, the interest rates were set by statute at a time when market interest rates were much lower. As market interest rates increased over time, programs that once received modest subsidies now receive deep ones. As a consequence, the demands for these loans has increased sharply as more and more individuals attempt to take advantage of the generous federal subsidies. The recent rapid growth in the student loan program is an example.

The establishment of a minimum federal lending rate might be a solution to this problem. Further, this Task Force might also consider altering the so-called "unsubsidized" rates on direct loans funded by the FFB. While the government does make a profit on these loans, the loan recipients often receive a loan at a rate below comparable market interest rates.

Reform or Limit Programs When there are Adequate Sources of Funds from Private Sector Lenders

Many federal credit programs have provided important benefits to our economy by either demonstrating the commercial viability of a certain type of loan or enterprise, or by providing credit for important segments of our economy at a time when financial and economic stress immobilized the private financial system. But as times change, the initial justification for establishing the program may no longer be valid. When private sector sources are available to meet the needs of current program recipients, consideration should be given to modifying, reducing or eliminating those federal credit programs that compete directly with private sectors lenders.

Conclusion

The U.S. Chamber believes that these proposals would make an important contribution to limiting the growth in federal credit programs and restoring a better balance between the private and public sectors. We urge this Task Force to carefully consider these reforms, and recommend that Congress enact the appropriate legislation to put them in place.

Senator GORTON. Dr. Utt, you have done both the members of the committee and the staff a great favor of assuming that we know how to read, and you have summarized your testimony very, very well, in a way which is not often done here. I have looked at your testimony. I think it to be very constructive, and I thank you for that. It is a first rate summary.

Dr. UTT. Thank you, Senator.

Senator GORTON. Mr. Huard?

STATEMENT OF PAUL HUARD, VICE PRESIDENT OF THE TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY JOHN D. SHILLINGBURG, PUBLIC ISSUES MANAGER, FMC CORP.

Mr. HUARD. Thank you, Senator.

My name is Paul Huard. I am vice president of the taxation and fiscal policy department of the National Association of Manufacturers. Accompanying me is John Shillingburg, manager of public issues of FMC Corp., one of our nearly 12,000 member firms. These firms account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial work force. I am pleased to be here to present the association's views on the Federal Government's credit activities.

The importance of your efforts to define the scope and examine the extent of Federal credit activities cannot be overstated.

Whether you include off-budget loans, loan guarantees, Government-sponsored enterprises, you find that the Federal Government is involved in more than 350 credit programs. These programs have proceeded to grow far more quickly than other forms of Federal spending.

PUBLIC SECTOR CROWDING OUT INDUSTRY IN CAPITAL MARKET

Since 1974, for instance, off-budget spending, the large part of which is composed of Federal credit activities, has grown at a rate nearly five times as fast as on-budget spending. Simultaneously, the Government's overall consumption of available credit has also continued to rise, as has been pointed out now, to in excess of 40 percent. This has led to crowding out by the public sector in the capital markets, which has serious implications for the economy.

Among other things, and this is obviously of direct interest to us, it diverts capital and resources away from manufacturing industries into public sector services. This makes it more difficult for private industry to service its own borrowing requirements, which in turn can result in slower rates of capital investment than would otherwise be possible.

Obviously, the problems associated with this magnitude of Federal credit activity were not created overnight. While many decisions that have been made along the way could be criticized, that would not assist our efforts today. Rather specific forward-looking recommendations are needed to remedy our current situation.

NAM has five proposals to offer, which will improve the efficiency and effectiveness of Federal credit programs.

BINDING LIMITS SHOULD BE ESTABLISHED

First, binding limits should be established in each budget resolution for all Federal credit activities. These limits should then be administered through the congressional appropriations process.

As you know, the credit levels included in the concurrent resolutions on the budget are only targets, and are therefore not enforceable. By fully subjecting credit programs to the provisions of the Congressional Budget and Impoundment Control Act of 1974, and allowing points of order against credit bills that exceed ceilings, you would unify Federal spending and credit activities.

Subsequent allocation and administration of these credit totals through the appropriations process would then provide the explicit congressional control and review of aggregate credit levels that are currently missing.

It is important to note that recommendations included in both pieces of legislation before you would affect gross lending activity. Net credit levels, which include repayments, are currently cited for most programs, but they tend to obscure the total level of Government involvement in credit activity.

UNIFIED BUDGET TOTALS SHOULD BE INCLUDED IN ALL FEDERAL SPENDING

Second, all Federal spending should be included in unified budget totals. Current projections of budget deficits fall short of stating the true amount of Federal indebtedness, because a portion of Federal spending is never included in outlay estimates.

For instance, when on-budget direct loans are sold to the Federal Financing Bank they are transferred off-budget, and no longer appear in deficit projections, even though they require the same level of Federal spending and borrowing as on-budget programs.

When a Federal agency completes a loan asset sale to the FFB, it reduces its recorded budget outlays by the amount of the sale. So the agency can then engage in further loan activities as its on-budget outlays remain below its annual appropriation.

EXISTING CREDIT PROGRAMS SHOULD BE REVIEWED BY CONGRESS

Third, Congress should begin to review all existing credit programs, and provide an evaluation of the economic impact of all future credit proposals. We think that some hard examination has to be done. These programs must be ranked by order of priority to determine which are important, which are not. Some critical questions need to be asked, including, but not limited to the following: Does the original need for the program still exist? If not, should the program be revised or phased out?

As requirements for entitlement programs are being reviewed and tightened, and discretionary programs are being eliminated, it seems only equitable that similar methods of control be applied to Federal credit activities.

Is the program cost effective, or are there more moderate methods available to achieve the same goal? Some programs turn out to be more cost effective when managed by the private sector or at the local level.

How much of a Federal subsidy is included in the interest rate set for the program? A review of the programs would provide the opportunity to determine if the interest subsidies are realistic in these inflationary times.

FEDERAL DEBT COLLECTING PRACTICES SHOULD BE REVISED

Fourth, Congress should review and revise Federal debt collection practices. Due to congressional mandate, or lack of uniform accounting procedures, the Federal Government is restricted in its ability to accurately assess risk factors for specific loans, and collect on delinquent loans.

Options to be considered in improving Federal debt management and collection procedures include, but are not limited to:

Developing strong and effective standards for screening and improving credit applications to insure that the potential debtor will use the credit for its intended purposes, and that the risk to the Government is fully assessed and recognized.

Creating uniform departmentwide collection policies, and providing adequate manpower and financial resources for debt servicing.

Developing uniform guidelines for granting deferrals, or rescheduling loans that are delinquent or in default.

Passing legislation that would permit more interagency disclosure of information, or the use of private sector credit bureaus to collect delinquent debts.

COMPILE STATISTICS ON ALL FEDERAL LENDING ACTIVITIES

Five, comprehensive statistics on all Federal lending activities should be compiled, and a periodic analysis of the economic impact of all Federal credit activities should be prepared.

Without a clear understanding of the current situation, you cannot be expected to produce effective guidelines and recommendations to monitor and restrain future credit legislation.

In conclusion, the fask force's efforts to improve the Federal Government's credit assistance activities are to be commended. The development and institution of a credit budget establishing credit targets in budget resolutions was an excellent beginning to define and restrain the growth of Federal involvement in the credit markets, but much more is necessary.

The National Association of Manufacturers supports your efforts to improve Federal credit activities and the full Budget Committee's desire to refine the budget process.

Thank you for this opportunity to present our views.

Senator GORTON. Thank you, Mr. Huard, for your wise counsel and your willingness to be with us today and for all the study that you obviously put in this subject.

PREPARED STATEMENT OF PAUL HUARD, VICE PRESIDENT OF THE TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

My name is Paul Huard. I am Vice President of the Taxation & Fiscal Policy Department of the National Association of Manufacturers. Accompanying me is John Shillingburg, Manager of Public Issues of FMC Corporation, representing one of our nearly 12,000 member firms. These firms account for nearly 80% of the nation's industrial output and 85% of the nation's industrial workforce. I am pleased to be here to present the Association's views on the federal government's credit activities.

INTRODUCTION

The importance of your efforts to define the scope and examine the extent of federal credit activities cannot be understated. However, your task is not an easy one. A number of problems are encountered even before the important issues can be addresssed. Innumerable sources must be consulted to glean the magnitude of federal involvement in the credit markets. Even after the information has been found and compiled, it often contains extremely complex and conflicting figures. However, it is just these types of problems that have contributed to the needs for these hearings.

Currently, the federal government is involved in more than 350 credit programs. These include on and off-budget direct loans, loan guarantees and government-sponsored enterprises. These programs have proceeded to grow far more quickly than other forms of federal spending. From FY 74 to FY 80, federal outlays grew by 115%. During this same period, off-budget spending alone increased by almost 600%, from $3.5 billion in FY 74 to a total of $23.6 billion in FY 80. Total liability has also increased dramatically. Outstanding on and off-budget direct loans grew from $61.5 billion in FY 74 to a total of $164 billion in FY 80. If the liability for defaults on federal loan guarantees is also included, an additional $118.8 billion was accumulated in the same period, for a total of $463.2 billion.

The federal consumption of available credit has also continued to rise. In 1981, estimates indicate that federal and federally-assisted borrowing absorbed 43% of available credit. This has led to problems of "crowding out" by the public sector in the capital markets which may have serious implications for the economy. It diverts capital and resources away from manufacturing industries into public sector services. Simultaneously, it makes it more difficult for private industry to service its own borrowing requirements, which results in slower rates of capital investment than would otherwise be possible. To what degree these factors have significantly slowed down real growth and capital investment is not absolutely clear. Nevertheless, major studies have demonstrated a strong relationship between demand for credit and interest rates.

Obviously, the problems associated with this magnitude of federal credit activity were not created overnight. Most of these programs were generated in response to real or perceived needs in our nation's past. Direct loans and loan guarantees date back to 1932 when strong efforts were necessary to revive our severely depressed economy. The Reconstruction Finance Corporation (RFC), the forerunner of such programs as the Export-Import Bank and the Small Business Administration, was one of the first credit programs established to begin rebuilding a devastated economy. In 1934, the Federal Housing Administration (FHA) was developed to assist potential homeowners who were having difficulty obtaining credit. In the 1970s, this program was expanded to encompass many new programs and has since become the single largest credit program.

Other programs were created to correct what were considered to be imperfections in the marketplace, redirect economic resources, or balance private and public interests. There is no question that many of these programs have successfully produced gains in technological and economic innovation, productivity and export levels. However, in the past 50 years, changes in the economy have occurred which were not taken into consideration as existing programs were expanded and new programs were developed. We have reached a point in our nation's economic development where the necessity for certain programs no longer exists. Programs that were originated to achieve one purpose have now extended beyond current needs or shifted their focus to include questionable objectives. Many decisions that have been made along the way could be criticized, but that would not assist our efforts today. Rather, specific recommendations are needed to remedy our current situation.

The NAM offers five proposals for this task force's consideration. We believe that these recommendations will improve the efficiency and effectiveness of federal credit programs:

1) Binding limits should be established in each budget resolution for all federal credit activities. These limits should then be administered through the congressional appropriations process. The creation of a credit budget for FY 81 was an important development in bringing federal activity under control. However, as you know, the credit levels included in the concurrent resolutions on the budget are only targets and are therefore not enforceable. Subjecting credit programs to the provisions of the Congressional Budget and Impoundment Control Act of 1974 and allowing points of order against credit bills that exceed ceilings would unify federal spending and credit activities. Subsequent allocation and administration of these credit totals through the appropriations process would then provide the explicit congressional control and review of

aggregate credit levels that are currently missing. Enactment of legislation such as that introduced by Senators Percy, Helms and Hatfield in S.265 and Representatives Mineta and Bethune in H.R. 2372 would serve as important first steps in these efforts. It is important to note that recommendations included in both pieces of legislation would affect gross lending activity. Net credit levels, which include repayments, are currently cited for most programs, but they tend to obscure the total level of government involvement. An accurate picture of all federal credit activity is essential if efforts to control the government's role in the credit markets are to be effective.

While much of the information necessary to monitor federal credit levels was not available a few years ago, many improvements have recently been made. CBO has developed an automated credit scorekeeping system that can compare congressional action on credit bills against the functional levels established in budget resolutions. As Dr. Rivlin testified, ..."the two years of experience with the informal credit budget have served to increase general awareness of the importance of federal credit activities and to develop supporting services to monitor these activities. An official credit budget would now be relatively easy to implement."[1]

2) All federal spending should be included in unified budget totals. Current projections of budget deficits fall short of stating the true amount of federal indebtedness because a portion of federal spending is never included in outlay estimates. When on-budget direct loans are sold to the Federal

---

[1] December 10, 1981 before the Task Force on Credit, Committee on the Budget, U.S. Senate, pg. 9.

Financing Bank they are transferred "off-budget" and no longer appear in deficit projections, even though they require the same level of federal spending and borrowing as on-budget programs. The spending that is currently carried off-budget should be brought on-budget in phases, over a three to four year period.

This is not a new recommendation for the NAM. On January 29, 1981, Alexander Trowbridge, President of the NAM, testified before the Committee on the Budget of the U.S. House of Representatives. At that time he recommended that "...Off-budget loans by federal agencies must also be brought under control by Congress. For FY 82, such programs are expected to add as much as $26 billion to an already top heavy budget, but this total is not included in total outlay projections and deficit figures. Yet, the impact of such credit requirements on financial markets is just as real. ...When a federal agency completes a loan asset sale to the FFB, it reduces its recorded budget outlays by the amount of the sale. The agency can then engage in further loan activities as its on-budget outlays remain below its annual appropriation. It is time to bring all federal spending transactions under one roof. Nothing is gained by placing some spending out of sight. That's like putting one's credit card bills out of sight when in actuality it's the credit card which should be put away. Congress should consolidate all its spending and borrowing responsibilities so that they can be reviewed and a true fiscal picture can be developed."

3) Congress should begin to review all existing credit programs and provide an evaluation of the economic impact of all

future credit proposals. As mentioned, many of these programs have been in existence for more than 40 years, without benefit of review by the annual appropriations process. Some critical questions need to be asked about these programs:

- Does the original need for the program still exist? If not, should the program be revised or phased out? As requirements for entitlement programs are being reviewed and tightened, and discretionary programs are being eliminated, it seems only equitable that similar methods of control be applied to federal credit activities.
- Is the program cost effective or are there more moderate methods available to achieve the same goal? Some programs turn out to be more cost effective when managed by the private sector or at the local level. In these circumstances, federal involvement may no longer be needed or beneficial.
- How much of a federal subsidy is included in the interest rate set for the program? A 3% interest rate established in the 1960s that is still in effect today provides a substantially higher subsidy for current program recipients than it did for original beneficiaries. A review of the programs would provide the opportunity to determine if the interest subsidies are realistic in these inflationary times. Many proposals dealing with interest subsdies have already

been introduced for Congressional consideration and more remedies to current problems will be brought forward as these topics become better understood.

One Federal credit program which NAM feels passes the test set forth in the preceding questions is the Export-Import Bank. Exports make a very important contribution to the U.S. economy -- every $1 billion dollars of exports creates 40,000 jobs, according to the Labor Department. The Eximbank plays an essential role in making some of those exports possible. In 1979 and 1980, for example, France, Japan and the U.K. each authorized over $60 billion in insurance guarantees and direct loans to support their exports. The U.S. authorized $22.1 billion -- one-third the amount authorized by the nations noted above. Thus, the need for competitive U.S. export financing has not diminished.

4) Congress should review and revise federal debt collection practices. Due to Congressional mandate or lack of uniform accounting procedures, the federal government is restricted in its ability to accurately assess risk factors for specific loans and collect on deliquent loans. Problems with debt collection initially began to surface in 1978 following reports from the General Accounting Office. Then, one of the members of this task force, Senator Sasser, held a special hearing in March, 1979 before the Senate Subcommittee on the Legislative Branch of the Committee on Appropriations to review potential improvements for federal agencies' debt collection practices. As a result of the issues raised by the GAO reports

and Senator Sasser's hearing, an OMB Financial Priorities Program was established early in 1979, followed by a Debt Collection Project later that year. The Project's recommendations, included in the Report on Strengthening Federal Credit Management, provides an excellent background and basis for future Congressional action.

To provide some idea of the scope of the repayment problem, statistics compiled by the Debt Collection Project indicate that of the $175 billion debt owed the government as of September 30, 1979, $25 billion or 14% were delinquent or in default. An additional $8.4 billion of loans were in some form of rescheduled or stretched-out status. Estimates of anticipated losses for uncollectable receivables by the agencies to the Project totaled another $6.3 billion and write-offs of bad debts in FY 79 amounted to $1 billion. It is clear that with figures of this magnitude, collection of these debts could assist all of our efforts to reduce rising federal deficits.

Options to be considered in improving federal debt management and collection procedures include developing:

- Strong and effective standards for screening and improving credit applications to ensure that the potential debtor will use the credit for its intended purposes and that the risk to the government is fully assessed and recognized.
- Uniform department-wide collection policies. Currently, collection policies vary greatly among programs, resulting in differing degrees of effectiveness.
- Adequate manpower and financial resources for debt servicing.

- Uniform guidelines for granting deferrals or rescheduling loans that are delinquent or in default. Current practices are erratic and almost always occur without penalty, interest escalation, or service charge.
- Legislation that would permit more interagency disclosure of information or the use of private sector credit bureaus to collect delinquent debts.
- Stricter accountability standards.

Many reports that are currently being conducted may provide further options for consideration.

5) Comprehensive statistics on all federal lending activities should be compiled and a periodic analysis of the economic impact of all federal credit activities should be prepared. As mentioned before, agency information on loan activity is often incomplete or incomprehensible. Comparisons are difficult to make due to differences in terminology. To develop any accurate assessment of current federal liability, extensive research and access to innumerable studies and data is required. Without a clear understanding of the current situation, you cannot be expected to produce effective guidelines and recommendations to monitor and restrain future credit legislation. Development of a credit budget, studies requested by this Task Force, and computer capabilities developed by the Congressional Budget Office have all been useful but more work is necessary. Again, legislation such as that sponsored by Senator Percy and Representatives Mineta and Bethune would help address this problem. Their bills require input from authorizing committees, the Banking Committees in both houses, the Treasury Department, the Federal Reserve Board and the Office of

Management and Budget. With unified efforts from all these informational services, reliable data could be compiled to assist in Congressional efforts to assess and establish responsible levels of federal credit activity.

SUMMARY

Your efforts to improve the federal government's credit assistance activities are to be commended. The development and institution of a credit budget establishing credit targets in budget resolutions was an excellent beginning to define and restrain the growth of federal involvement in the credit markets, but much more is necessary. Binding credit levels must be established and implemented through the Congressional budget and appropriations process. Unified budget totals should include all federal credit activity so that the true extent of federal involvement can be assessed. All existing credit programs should be reviewed and proposed credit legislation should be analyzed to determine need, effectiveness and economic impact. Whenever feasible, programs should be eliminated or curtailed. Information should also be utilized more accurately to determine direct and contingent federal liability. Federal debt management and collection practices should be evaluated and strengthened to provide more systematic credit reporting that can assist in improving repayments. Finally, a more comprehensive reporting system should be developed to analyze federal credit data. Accurate assessments of problems require complete and accessible information.

The National Association of Manufacturers supports your efforts to improve federal credit activities and the full Budget Committee's desire to refine the budget process. Thank you for this opportunity to present our views and we look forward to working with you to resolve some of the problems that have been reviewed today.

Senator GORTON. Our third witness will be Mr. Motley.

STATEMENT OF JOHN J. MOTLEY, DEPUTY DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you, Mr. Chairman.

I am John Motley, deputy director of Federal legislation of the National Federation of Independent Business.

I want to thank you and the committee for this opportunity to appear here today to discuss what we believe is a very serious problem for small business in this economy.

With your permission, I would like to submit my testimony for the record and summarize it as briefly as I can.

Senator GORTON. Your entire testimony will be printed in the record in full.

Mr. MOTLEY. Thank you, Mr. Chairman.

INTEREST RATES ARE NO. 1 PROBLEM OF SMALL FIRMS

I do not think I would be surprising anybody if I said that interest rates are the No. 1 problem facing small firms across this country today.

NFIB has been running a quarterly report on small business for approximately 8 years. In the second quarter of 1981, interest rates and credit problems for the very first time became the No. 1 problem facing those small firms that we surveyed. In the last quarter of 1981, 36 percent of the respondents reported that interest rates and financing problems were their biggest problem in today's economy. This is in comparison to only 5 to 7 percent of the reporting firms in the period 1976 through 1979.

High interest rates affect small businesses, I believe, more dramatically than they do other members of the business community, and they affect them in three ways:

No. 1, they dampen consumer demands. No. 2, they retard investments and growth. And, No. 3, they begin a spiral of survival borrowing which usually ends in the profit margin of the business being shrunk so badly that the firm has to close its doors forever.

BORROWING AND CREDIT ACTIVITIES AFFECT SMALL BUSINESS

We believe in NFIB that this problem facing small business is directly related to Federal borrowing and credit activities. Counter to what has become a popular belief or saying in circles in this country, we believe that deficits do count. We believe that $100 billion borrowed by the Federal Government is $100 billion which is unavailable to the private sector and particularly to small business for borrowing, productivity and growth. Borrowing and credit activities of the Government, we believe, affect small business in two ways:

No. 1, there is a finite pool of capital which is available. Small business, contrary to everything that is said about equity financing, finances itself almost exclusively through debt. That means that they have to walk down to the corner bank to get the money that they need to grow. Heavy Federal borrowing in the financial markets of the country simply crowds these less creditworthy businesses out of the marketplace.

Second, the other credit activities of the Federal Government not only add to the deficit and causes more borrowing, but it also does something which is a lot more subtle. It begins to reallocate credit within the small business community. What happens here is that as the less creditworthy firms are rationed out of the marketplace by either the supply of credit or by the cost of credit, the Federal Government comes along and makes them creditworthy again by guaranteeing their debt which simply means that the next level of firm which also has to borrow and which are more creditworthy than the first are pushed out of the marketplace because the funds are not available.

CONTROLS NEEDED FOR BORROWING AND CREDIT ACTIVITIES

NFIB believes that something has to be done to bring this situation under control because if it does not, there are an awful lot of small businesses that will not be able to participate in the recovery that we all hope will be coming later this year.

We have three specific suggestions. No. 1, the committee should move to bring all off-budget items onto the budget immediately.

No. 2, the total amount of credit expended should be subject to the control and scrutiny of the Budget Committees.

No. 3, we would ask you to try and determine to what extent, if any, the Federal grants process is encouraging or aiding and abetting off-budget activity of State and local governments. Because as alarming as this activity is at the Federal level, it is more alarming on the local and State level.

I would add just one other recommendation that is not in our testimony but we certainly do concur with, and that is a recommendation of the National Association of Manufacturers that the Federal Government improve its debt collection activities. And we would suggest that you might even turn to the private sector to do that for you.

Thank you, Mr. Chairman. I will be glad to answer any questions that you might have.

Senator GORTON. Thank you, Mr. Motley.

PREPARED STATEMENT OF JOHN J. MOTLEY, DEPUTY DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, NFIB, in excess of 500,000 small and independent member businesses, appreciates this opportunity to express our views on federal credit and off-budget activity. These issues are of vital importance to small business for numerous reasons, not the least of which is their impact on private credit markets. We, therefore, applaud the conduct of these hearings and hope they lead to substantive change.

The Small Business Economy

Within a month, NFIB will be publishing an assessment of the 1981 small business economy. That report begins,

> "Nineteen eighty-one was a bad year for small business. The fact that 1981 constituted the second consecutive bad year only compounded the problem. Not since 1978 has small business experienced a reasonably good period.
>
> Caught between unprecedented interest rates, a high--even if declining--inflation rate, and slow sales, small business earnings were badly squeezed. The population responded by reducing employment, investment, and inventory as best it could. But many simply didn't make it."1/

It is a bleak, but fair summary.

In July respondents to the NFIB Quarterly Economic Report for Small Business ranked "Interest Rates-Financing" as their single most important problem more frequently than any other for the first time in the survey's history. By October, 36% rated it their most important problem compared to 5-7% during equivalent periods in 1976, 1977, and 1978.[2/] Those required to borrow (less than half the population) obviously felt the problem more than did others.

High interest rates, both nominal and real, affected small business in three principal ways:

1. They shut down consumer demand (sales) in interest sensitive sectors such as construction. Much has already been made of this development, and we will not repeat it. However, we would note that the construction industry, particularly housing, is one of two major industrial sectors dominated by small business.
2. They retard reinvestment. Equity capital for small business is a popular and much discussed topic, but it is a plain fact that debt is the vital capital source. Debt is the vehicle by which most small businesses reinvest and grow. Unfortunately, high interest rates (in conjunction with their uncertainty) make previously profitable ventures unprofitable. NFIB estimates that in 1981 about 15% fewer small businesses than in 1979 made a capital investment of more than $5,000 and total outlays were down as well[3/].

3. They become an especially intense problem for small firms operating on small profit margins which have to borrow regularly or which have cash flow problems. The combination of a stagnant economy and constantly rising costs (i.e., energy, labor and inventories) diminish many firms' cash flow to the point where they were forced to borrow for financing daily operations. The high rates charged on those loans further reduces earnings. We term this vicious spiral "survival borrowing".

The weight of the ongoing recession and the accompanying fall in business loan demand has fostered a drop in short-term interest rates. However, if the small business community is to participate in the next economic recovery, and/or if we are to have any recovery at all, efforts must be made to prevent another run-up in interest rates which would be cataclysmic.

The unsettled state of the credit markets can largely be attributed to the federal government's increasing intervention in the private credit markets. To the extent that the private sector must compete for the same limited supply of funds, federal (state and local as well) preemption of credit can put upward pressure on interest rates. In fact, the federal participation rate in the credit markets has risen steadily over the last decade, and unless the trend is reversed, interest rates are likely to reach new record levels if and when we enter a strong recovery.

There are two types of intervention for present purposes: borrowing to finance the debt and extention of guarantees which change the economics of lending.

Deficits Do Matter

The argument is made that we don't have to worry about deficits; projected deficits are actually smaller as a percentage of GNP than was the 1975 deficit; further, if we expand the pool of savings sufficiently, a la Germany and Japan, no crowding out will occur regardless of the deficit's size. Today's terminology is "deficits don't matter." NFIB doesn't agree.

Deficits do matter, and they matter for reasons considerably beyond the public perception that they do matter. While we would agree that an obsession over the deficit to the exclusion of other factors influencing interest rates is unjustified, the huge deficits projected by both the Administration and the CBO extending far into the future, the presumed low-growth monetary policy of the Fed, the highly questionable ability of the economy to generate sufficient savings in the near term to compensate for the increase in federal deficits, the perception that deficits matter (held on Wall Street as well as Main Street), and state and local fiscal policies, force NFIB to the conclusion that this country has a very serious deficit problem. One hundred billion dollar deficits simply mean one hundred billion that private sector cannot utilize.

Federal Credit and Off-Budget Expenditures

During fiscal 1980, government consumed over 40% of all credit available. The federal government alone was responsible for 35.7%.[4/] The unique part of federal borrowing, however, is that it is completely insensitive to price. The federal government will pay whatever is necessary to fulfill its borrowing needs. Therefore, the nation's largest borrower receives its credit first, last, and always without regard for consequences to other borrowers.

What is occurring is none other than a massive credit allocation scheme. It occurs not only because government saps up incredible amounts of capital to directly fund its deficits, but also because its guarantees redirect the private credit markets to achieve federal objectives. Approximately, $90 billion in guarantee transactions occurred in 1981 (up from $43 billion in 1977).[5/] With sums such as these being extracted from the private markets, is it any wonder the price of credit is outrageous?

Essentially, loan guarantees and off-budget expenditures escape Congressional control. As the CBO pointed out, several problems result.[6/] First, annual growth in these programs is largely uncontrolled. That implies the lack of priority establishment among government borrowers, let alone between government borrowers and private borrowers. Second, borrowers not eligible for government lending programs may be rationed out of the market either through price or availability. Third, government loans often purport to be free. They are not. For example, Amtrak and D.C.'s Metro have received guaranteed financing for construction and neither has been able to maintain debt service.

The second of these points is the one directly impacting small business. Small business can find two types of adverse credit market conditions: (1.) Lack of credit availability such as the 1974-1975 period. Here credit simply isn't available no matter what the price a potential small business borrower is willing to pay; or (2.) The price of credit becomes so expensive, such as the current period, that a number of potential small business borrowers are rationed from the market. In this situation, there is plenty of money if one can afford it.

The price rationing scenario finds that those small firms with the weakest balance sheets are those first rationed. In other words, those with the highest risk of failure to repay principal and interest are the first to be pushed from the market. As the price of money rises, more and more firms have a greater and greater likelihood of non-repayment. Increasing numbers of firms thereby become rationed from the market. The relationship obviously is not perfect because many financial institutions are involved with small business debt restructuring in order to avoid greater losses from a bankruptcy. But what is anomalous is that government loan programs which are usually intended to help the financially weak draw private resources which could otherwise be used for that same class. In other words, there is a questionable net gain for the classes designed to be helped.

NFIB estimates that a maximum of 2% of operating small businesses with employees (that excludes all self-employed with no employees, potential entrepreneurs, etc.) receive some type of SBA loan or guarantee in any year. In 1978 and 1979, NFIB estimates that an average of 47% of all firms were borrowing at least once a quarter; in 1980 and 1981 that figure had dropped 3 percentage points (10%).

Since the early '70's, net off-budget spending has increased from nothing to over $24 billion. But the federal government is still a relative late-comer to the off-budget process. States and localities have been practicing it for years and have developed off-budgeting into an art. Pennsylvania and its local jurisdictions contain 12,465 off-budget enterprises.[7/] Those enterprises possess $4.8 billion of debt in contrast to the $2 billion of "full faith and credit" debt. On a national scale, public authorities issued $23.4 billion in securities (1979) while all state and local governmental units issued only $20 billion. These special districts accounted for 54% of all state and local issuances, up from 31% just nine years before.

The figures cited above are of more than academic interest. They raise two critical points: first, the history of public finance in many states and localities is one of explosive growth in off-budgeting, particularly in recent years. Will the federal government follow suit? NFIB hopes not, but it certainly has made an ominous start.

Second, to what extent, if any, has the federal government tacitly coerced or aided states and localities to go off-budget? We simply don't know. However, the question is of more than passing interest. Off-budget agencies at the state and local levels have authority to borrow and do so with regularity. While they differ from the federal government in the sense that their borrowing is price sensitive, their borrowing effects are the same. Both serve to force out others.

Recommendations

1. Bring all off-budget items onto the budget immediately. The experience of state and local governments leads us to conclude that the sooner this step is taken, the better off we will be. NFIB can find no justification for off-budget expenditures. They merely serve to conceal the true nature of federal spending and deficits. In an open society, that is neither desirable nor necessary.
2. The total amount of credit extended (in contrast to any nets) should be subject to the control and scrutiny of the Budget Committees. The philosophy behind the institution of the entire budget process was one of reviewing and coordinating the total budget in terms of its economic impact. Certainly, federal credit activities have an enormous impact. Omitting them undermines the very purpose of the budget process.

3. Determine to what extent, if any, the federal grants process is encouraging or aiding and abetting off-budget activity of state and local governments. Off-budget at the state and local levels is no more acceptable than at the federal level. If indeed the federal government is in a position of tacitly encouraging such activity, it must find means to at least be neutral on the question.

ENDNOTES

1. The Small Business Economy 1981, (National Federation of Independent Business: San Mateo, California), forthcoming.

2. Quarterly Economic Report for Small Business, National Federation of Independent Business: San Mateo, California), various issues.

3. Ibid.

4. The Budget for Fiscal Year 1982, Special Analysis, Office of Management and Budget, (Government Printing Office: Washington, DC), 1981.

5. Center for the Study of American Business, Washington University, St. Louis, Missouri.

6. Federal Credit Activities: An Analysis of the President's Credit Budget for 1981, (Congressional Budget Office: Washington, DC), February 1980.

7. Bennett, James T. and DiLorenzo, Thomas J., "How Government Evades Taxes," Policy Review, Winter, 1982

Senator GORTON. The one white light on the clock behind you indicates that there is a vote in progress on the floor of the Senate. We will have to recess this hearing for somewhere between 10 and 15 minutes while I go and vote. We do have a number of questions for you because of the interesting nature of your testimony. I intend to add one question to the printed list, and I will give you a little hint in advance of it so that you can think about it.

It is off the specific subject which we have here, but each of you has expressed his concern with the impact on the economy and on potential economic recovery of tremendously high interest rates which we face at the present time. It has obviously had a negative impact on all of your memberships.

I would appreciate a brief comment by each of you, if you wish to make it, on whether or not you believe that your members would prefer that the Congress come far closer to balancing the Federal budget, both the cash budget and the credit budget, than the figures which are implicit in the administration's proposals would indicate its recommendations to be.

That is a rather easy question because I am sure you are going to say yes. I wish you would then go further and tell me whether or not in doing so it would be advantageous to the people you represent to balance even if it meant that as much as 50 percent of that attempt to balance came out of additional revenues as against less expense. You have got 15 minutes to think that one over while I go vote. We will be back and start as soon as I can.

[Short recess.]

Senator GORTON. Gentlemen, do any of you wish to comment on the question with which I left you?

RAPID PACE OF FEDERAL SPENDING FUNDAMENTAL PROBLEM

Dr. UTT. The chamber is very much concerned about the deficit and believes, at least, as financial markets are reacting today, that the deficit projections are a contributing cause of high interest rates.

However, we believe that a deficit is a symbol and symptom of a more fundamental problem—that Federal spending continues to grow at a rapid pace. The true measure of crowding out is the share of the gross national product accounted for by Federal spending. Despite the budget reductions enacted last year, the Treasury outlay statements for the first quarter of this year that we are going to increase that share from last year's record 23 percent. To us, the real source of the problem is spending. That is where we think the focus of the Congress attention ought to be. If you try to limit the deficit by raising taxes, you are essentially acknowledging failure to solve the true source of the problem. Taxes are just like borrowing; they are another way of extracting resources from the private sector, and can, in some circumstances, be just as debilitating.

Mr. HUARD. I, in large part, agree with the views expressed by the chamber.

LOOK AT DEFICIT IN PERSPECTIVE

An additional comment I would like to make is the question of perspective. Certainly the NAM is concerned about the size of the deficit. We are not going to say deficits do not matter. What we will say is they may not matter as much as some people think because you have to look at it in perspective.

Now, people are horrified at $100 billion deficit. What they are looking at is a deficit in raw dollar terms when, if you look at it as a percentage of the gross national product, it is not that much different from the 1976 deficit. And 1976 was not that bad a year.

I could just as easily say, and I am sure I would not get much sympathy for my arguments, that taxes are higher today than they have ever been, higher than they were under the Eisenhower administration. That is true if you look at it in terms of raw dollars. But if you look at it in terms of the gross national product, the national economy, now taxes have been lowered, and rightfully so, for the purpose of stimulating investments in capital formation. The problem is, for instance, spending is at 23 percent GNP and taxes are 21 percent. I do not think the solution is to raise taxes up to 23 percent of GNP. I do not think the statistics will show that that level of taxation is consistent with any kind of economic recovery. So that we are concerned about the deficit but we do not think the answer is to raise taxes, to bring things into balance, and to just leave spending alone.

Another point, and I will let this one go after this, is that a principal goal of the 1981 Tax Act, particularly providing 3 years of cuts scheduled on into the future and a known system of capital recovery for business, was to provide a stable, known, predictable system of taxation which businessmen and individuals could use for capital and investment and savings planning. If less than 6 months after that system goes into effect, you are talking about taking 50 percent of it back, or delaying it or rescinding parts of it, to me you undermine a serious goal of that tax legislation.

Thank you.

Senator GORTON. Mr. Motley?

Mr. MOTLEY. Senator, I think it is fair to say that NFIB's position during 1982, on the budget, will be determined by what we feel is the relationship between interest rates and the deficit or the perceived relationship between interest rates and the deficit.

TAX INCREASE NOT SUPPORTED BY NFIB

We are not supporting a tax increase at this time. I doubt that you would get a positive response on that from our membership if you would ask them the question. But I do see, and we have talked about this a great deal, the possibility of NFIB supporting a package of cuts and revenue-raising measures that would have significant downward movements on the deficit even though parts of that package would be unacceptable to us.

So we are pretty much in the position right now of encouraging whatever can be done to reduce the size of the proposed budget or the perceived deficits and holding our position on the individual parts of that package until we see what they look like.

If I can make just one other comment as far as last year's tax activities are concerned. I think were are all pretty much involved in what passed both the Senate and the House and was eventually signed into law. I think the one thing that we forget is that we did get involved in somewhat of a bidding war on the other side the last time around, and a number of things ended up in that bill that none of us really wanted to see there or were unwilling to accept in the beginning. And the size of it was certainly a great deal larger than a lot of us wished and testified for in the beginning of the process. I do not see where it would be anathema to us to raise revenue by adjusting some of these excesses. We would certainly hold our positions on the various different elements of it until we saw the particulars of those elements.

Senator GORTON. Thank you.

Mr. Motley, in your formal testimony, you stated that given the crowding out or pricing out of small businesses that is going on at the present time, it is likely that the benefits of Federal direct loans and loan guarantees to small business are being offset by the cost of higher interest rates which results from those very credit programs. I would like to ask the other two whether or not you agree with that characterization, and all three of you whether you would be inclined to support major restraints and Federal credit activities, even those activities which benefit our own members, revenue bonds, or whatever they are, in order to ease pressures on general interest rates?

CREDIT PROGRAMS DESERVE PRIORITIZATION

Dr. UTT. Yes; I think our membership is willing to make that sacrifice, as long as they feel it is fair and equitable and across the board. I think the credit programs deserve some prioritization, though.

Many of the programs are less beneficial than are others. Some are more extravagant than others. I would like to see the focus of concern directed in these areas with emphasis on in the need for interest rate reforms.

In the recent past, the chamber has proposed, endorsed, or acknowledged loan program reductions in areas that affect business. The chamber has endorsed the elimination of the SBA direct loan program. And despite our considerable support for in the Export-Import Bank, we concurred with the President last year in his budget reductions, despite the fact that our own recommendations prior to that were for Eximbank outlays substantially higher than were ultimately proposed.

Mr. HUARD. Senator, I think that if there is a cutback that is perceived as fair, as being across the board, and not, frankly, limited to the Federal credit area, I think our membership is willing to support expenditure reductions, including reductions involving Federal credit programs, even though there is some pain to some of our membership.

Our relatively pugnacious position on taxes is because of our belief in the correctness of the President's tax program, but we have consistently, since the beginning of 1980, taken a position that where it is spending reductions, we believe that Government activity in all areas, and we would not, frankly, exempt the defense budget, it has to be given a lot of close examination, and reductions have to be made wherever possible, and yes; our members would take it even though there would be some pain.

KEY TO NFIB'S POSITION IS "FAIRNESS"

Mr. **Motley**. I think that the key to NFIB's position has to be the word that was mentioned by the other two witnesses, and that is "fairness" as far as cuts in Federal credit activity is concerned.

Before the House Budget Committee last year, NFIB's president recommended 30 percent cuts in lending activities. That is about what the administration came down with, and what was enacted into law.

I think, generally speaking, we feel that SBA's lending programs are were very positive programs in the fifties, that do not suit the business needs of the eighties, and we have been much in favor of getting them out of the Government and into the private sector over the last couple of years, which is about a 180° reversal from where we were 5 or 6 years ago.

So long as there is fairness involved, and so long as all segments of the economy benefiting from these lending programs, are asked to make sacrifices, I would think NFIB would support such reductions.

Senator **Gorton**. Each of you testified to the proposition that the effect of a Federal loan guarantee was simply to put a different person or group or organization in front of the credit line and push someone else out the back end of that line.

OPINIONS MIXED ON WHO IS AFFECTED MOST BY CROWDING OUT

Could each of you, or some of you, give me an idea as to what type of business firms are usually most affected by this crowding out or pricing out? Perhaps I will start with you, Mr. Motley.

Mr. **Motley**. Senator, I would think that you have to look at the credit needs of various different segments of the business community to come up with that segment which is most affected by crowding out.

Generally speaking, manufacturing firms, construction firms, possibly heavy industrial firms, can put off their borrowing needs more, or have other borrowing or fundraising alternatives than, let us say, retailers. Retailers are generally put in the position where they have to borrow, either to increase inventories, or to simply maintain them. Especially if interest rates are going up. They get into a spiral of borrowing, if interest rates go up and profit margins are shrinking, they generally get into a cash-short position where they have to go to the bank to borrow, to maintain inventories, and even to pay Federal taxes, expecially deposits of things like payroll taxes, which are not related at all to the profits of the business.

So I would say those types of firms, which are injured the most by crowding out, would be retailers who tend to have to go into the financial markets more than other types of firms do.

Mr. **Huard**. I do not think we have ever been able to identify any particular sector that would be hurt more than another sector, or any particular type of firm. I think our concern is the one Mr. Motley expressed in the summary of his remarks, is that it turns things upside down.

You have more companies who are more credit worthy than others, who go bankrupt, because the less credit worthy ones were helped by a Federal-assisted program.

We think, in what is supposed to be a free enterprise economy, there is something questionable about that result, and it ought to be looked at more closely.

Dr. UTT. I think probably the firms in the most tenuous financial condition; business firms that are under the most economic stress right now. Because banks do not have the level of funds that they could otherwise have available, they simply ration their funds to their better credit risks. Those suffering from economic problems are rationed out as banks and commercial finance companies raise their credit standards in reaction to considerably higher interest rates.

Senator GORTON. I would like to thank each of you for being with us today and for your most successful efforts in helping us deal with what is a very serious problem. I would say that I hope that we will be successful in adopting at least a number of the suggestions which you have made. I appreciate your being here.

The second panel will consist of Dr. Riedy, Mr. Storey, and Mr. Waldo.

Dr. Riedy, you may proceed.

STATEMENT OF MARK J. RIEDY, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Dr. RIEDY. Mr. Chairman, my name is Mark Riedy. I am executive vice president of the Mortgage Bankers Association of America.

It is all too well known that inflation and record interest rates have devastated the delivery systems for housing and mortgage credit in recent years. MBA strongly supports the anti-inflation, prorecovery objectives of the administration and the Congress as the only permanent solutions to the long-range problems of the housing and mortgage finance industries.

In the process, however, we are concerned that Government policies should not worsen the housing crisis by ill timed or misdirected actions that would increase the cost and reduce the availability of mortgage credit, especially for first time home buyers or moderate- and middle-income families who already face severe housing affordability problems.

MBA believes that the imposition of restrictive credit budget ceilings on the nonsubsidized FHA mortgage insurance programs and the Government National Mortgage Association mortgage-backed security [GNMA-MBS] program would be both ill timed and misdirected.

HOUSING SECTOR BADLY DAMAGED

Millions of American families are already frustrated in their home buying plans, and the housing sector has been so badly damaged that it will not be able to assume its historic role in helping to stimulate the national economic recovery that is the goal of public policy. Restrictive credit budget ceilings on the nonsubsidized FHA and GNMA-MBS programs will exacerbate those problems.

Moreover, because the GNMA-MBS security is the only vehicle currently successful at tapping the Nation's capital markets for new residential mortgage credit—at no cost to the Government—to place restrictive limits on this program will reduce its value as a role model for the development of, and a benchmark for the pricing of conventional mortgage-backed securities, which are critically needed for the future viability of the conventional mortgage market.

MBA has opposed the imposition of any credit budget limits on the FHA and GNMA programs, which have functioned extremely well on a demand-responsive basis for many years. It might be appropriate for targets, rather than absolute ceilings, to be imposed on these programs, as a means for the Congress to monitor the growth of these contingent liabilities.

FHA AND GNMA-MBS PROGRAMS EARN PROFIT FOR GOVERNMENT

However, it is important to recognize that the nonsubsidized FHA and GNMA-MBS programs have substantial reserves, are user fee supported on a self-sustaining basis, and are collateralized by sound residential real estate. In reality, these programs earn annual profits for the Federal Government, and thereby reduce the Federal deficit, not increase it. They do not pose meaningful fiscal threats as contingent liabilities of the Federal Government.

In recent years, more than 70 percent of all nonsubsidized FHA and VA loans have been sold through the vehicle of the GNMA-MBS. Since its beginning, more than $120 billion of GNMA securities have been issued and sold to capital market investors. In the process, several million moderate- and middle-income and veterans' families were enabled to compete for home mortgage credit on the same borrowing plane as large corporations, the Federal Government, and other large users of credit—rather than being crowded completely out of the mortgage market.

The vital countercyclical role of FHA and VA loans packaged as GNMA securities is most critical and visible during periods of credit restraint, when conventional mortgage lenders increase downpayment requirements substantially or simply withdraw from the mortgage markets—as more than one-third of all S. & L.'s have done, currently, according to a recent survey.

What good is the availability of ample supplies of private mortgage insurance for conventional loans when conventional lenders reduce or eliminate the sources of conventional mortgage credit? It is no surprise, therefore, that the market share of FHA-insured and VA-guaranteed loans increases during periods of credit restraint, because GNMA securities can still attract mortgaqe capital, while private mortgage insurance capacity becomes excessive due to the dearth of conventional loans needing such insurance. In this connection, let me also point out that even though VA loans are not covered by credit budget ceilings, restrictive ceilings on the GNMA program would adversely affect the availability of VA loans as well as FHA mortgages, because most VA loans are packaged and sold in GNMA securities.

GNMA-MBS INVOLVES ONLY PRIVATE DOLLARS

It is also important to realize that the GNMA-MBS, with its underlying FHA and VA collateral, involves only private dollars to be invested in home mortgages. There are no net Government costs or outlays in these programs. Moreover, the nonsubsidized FHA and VA loans are offered at effective interest rates that do not differ materially from rates on commercial loans.

The Government-insured and guaranteed mortgages are able to assure the availability of low downpayment loans during all phases of the interest rate cycle, however, even when conventional mortgage credit evaporates, because of the existence of the GNMA vehicle for attracting capital market investors on a consistent basis. The GNMA securities are attractive to investors partly because of their full faith and credit guaranty, but equally importantly, because of their ready secondary marketability, convenience and standardization.

In 1980, virtually half of all single family mortgages originated were sold in the Nation's secondary market, a growing phenomenon that mandates the creation of conventional mortgage-backed securities [CMBS] if the tremendous backlog of mortgage demand—not to mention the unprecedented large prospective demands for mortgage credit—are to be satisfied on an affordable basis during the decade of the eighties.

DEVELOPMENT OF CONVENTIONAL MORTGAGE-BACKED SECURITIES UNSUCCESSFUL

For several years, therefore, MBA and other groups have labored to develop viable conventional mortgage-backed securities, unfortunately, without great success to date. In the development of the market for conventional mortgage-backed securities, the continued availability of the GNMA-MBS is absolutely essential, both to serve as a role model for and to act as the benchmark for the pricing of CMBS.

The CMBS market, in the long run, must dominate the secondary mortgage market, just as conventional loans historically dominated the primary market, except in periods of severe credit restraint. This evolution will occur under the natural forces of market demand, as it should. However, artificial credit budget restrictions on the GNMA-MBS program, and thereby on the FHA and VA loan programs, will stymie rather than stimulate the development of the CMBS. And, in the process, restrictive credit budget limits would destroy the only remaining successful means of delivering mortgage credit to countless moderate- and middle-income families and veterans—at no cost to the Government—at a time when housing affordability and availability are already suffering crisis conditions.

Thank you.

Senator GORTON. Thank you, Dr. Riedy.

PREPARED STATEMENT OF MARK J. RIEDY, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. Chairman and Members of the Task Force, my name is Dr. Mark J. Riedy. I am Executive Vice President of the Mortgage Bankers Association of America.* MBA is the trade association of the Nation's mortgage banking industry. Accompanying me are Burton C. Wood, MBA's Legislative Counsel, and Sharon M. Canavan, MBA's Associate Legislative Counsel.

We appreciate the opportunity to appear before you today to express our views on proposed limitations on Federal loan guaranty and insurance programs. Specifically, our comments will focus on the disruptive effects of setting ceilings on the non-subsidized, user-fee supported Federal Housing Administration (FHA) mortgage insurance and Government National Mortgage Association (GNMA) mortgage-backed security (MBS) guaranty programs, as well as the possible impact on the Veterans Administration (VA) home loan guaranty program.

---

*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- Mortgage Banking Companies
- Mortgage Insurance Companies
- Life Insurance Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Pension Funds
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005;
Telephone: (202) 861-6500.

Introduction

MBA opposes setting limits on these self-supporting programs. However, if limits are to be established they should be set high enough to accommodate demand. The Administration in its FY 1983 budget proposal has requested that the GNMA-MBS program be restricted to $38.4 billion, and the FHA mortgage insurance programs be limited to $35 billion. The Administration has also proposed a "supplemental reduction" in the FY 1982 GNMA-MBS level of $20.25 to bring it to a ceiling of $48 billion. MBA is seriously concerned that even if interest rates remain at or near their current levels, the $38.4 billion limit for the GNMA-MBS program will prove insufficient. If interest rates drop and proposals to create several alternative financing proposals are successful, the FHA commitment ceiling may prove insufficient. Therefore, MBA recommends that the FY 1983 ceilings be set at the same limits established for FY 1982 -- $40 billion for the FHA mortgage insurance programs and $68.25 billion for the GNMA-MBS program. MBA also opposes any reduction in the FY 1982 GNMA-MBS levels of $68.25 billion.

In addition, MBA supports the inclusion of procedural protections in a credit budget for these self-supporting programs. First, anti-impoundment protections should be included so that the congressionally approved limits cannot be rolled back by administrative fiat. Second, a system to alert the appropriate committees, if the ceilings are approached, should be instituted to give Congress sufficient time to react. Third, the procedures established for adjusting ceilings in the event they are reached should be streamlined, to avoid market disruptions. Prior to 1961 when limits were placed by the authorizing committees on FHA insurance levels, these ceilings created serious disruptions in the mortgage market whenever they were reached. Recognizing this, Congress instituted the practice of annual FHA insurance activity authorizations, but no longer set dollar limits.

MBA believes that reductions in Federal spending are necessary in order to decrease interest rates and restore investor confidence. The FHA mortgage insurance and GNMA-MBS programs, however, rely solely on private investment funds. There are no Federal dollars expended under these programs. Nor are there any ties to the Federal Financing Bank (FFB), as the private lender, not GNMA, is responsible for marketing the GNMA securities to investors through Wall Street dealers. To have any impact whatsoever on financial markets, reductions in Federal spending must be real ones, not simply artificial reductions on paper. Proposed reductions in the FHA mortgage insurance and GNMA-MBS guaranty commitment levels will not have an ameliorative effect on interest rates and on the financial markets unless marginally qualified home mortgage borrowers are rationed out of the markets because they are unable to obtain mortgage financing at all. Only if the dollar volume of mortgage credit is itself reduced, will Wall Street consider proposed reductions in these programs as the financial equivalent of direct spending reductions, as proclaimed by the Office of Management and Budget.

Thus, the real issues involved in these proposed reductions are whether the Federal government intends to reduce its commitment to housing and mortgage finance, by restricting programs that enhance the availability of adequate supplies of mortgage credit, especially for moderate- and middle-income families and first-time homebuyers, and whether these reductions signal an intent to reduce, overall, the share of credit that has historically been utilized in financing mortgages. These issues are being addressed at a time when the potential demand for home mortgage credit has never been stronger.

The Federal government, long ago, recognized the social need for, and importance of, housing its citizens, and responded in an appropriate manner by creating programs to fulfill this social goal. Not only have the non-subsidized FHA programs and the GNMA-MBS program worked efficiently by not incurring any costs that drained tax revenues, but they have been profitable and achieved a remarkable success in structuring a mortgage finance delivery system that provides readily available sources of mortgage credit throughout all phases of interest rate cycles, and involves private sector lenders and investors to a maximum degree.

Neither the actuarially sound FHA mortgage insurance programs nor the GNMA-MBS guaranty program result in any direct subsidy, because user-fees cover all expenses for administration of these programs, as well as default losses. However, the benefit derived from the FHA insurance or GNMA guaranty has been characterized by some as an "indirect" subsidy. Though we are unsure as to what constitutes an indirect subsidy in this case, we believe that it could only lie in two areas—subsidy to a homebuyer or subsidy to an investor. Does the homebuyer receive a subsidy through the use of FHA-insured mortgages? Though the FHA contract rate is usually set somewhat below the rate on conventional loans, the effective rate (the contract rate plus "discount points" or non-refundable loan fees equal to one percent of the loan amount) is generally about equal for both types of mortgages. With no differential in the effective rate, it is difficult to find a subsidy to the homebuyer. For the investor to be subsidized, he must receive a higher return on FHA-insured loans than on conventional loans. Once again, this is simply not the case. In fact, given the liquidity advantages of the GNMA security, yields on conventional loans are normally a bit higher than those of GNMA securities (see subsequent tables on page 9). The real benefit enjoyed under these programs is not a subsidy, but the capital market efficiency of the GNMA security, and the standardization offered by the underlying FHA and VA loan instruments.

The non-subsidized FHA mortgage insurance programs provide an unfailing source of private mortgage credit for low-downpayment, fixed-rate loans to homebuyers. The

GNMA-MBS program ensures lenders of ready placement in the secondary market for FHA and VA loans. In effect, the existence of the GNMA-MBS program places the individual consumer on the same plane in the credit markets as large corporate borrowers and the government (see subsequent table on page 13). A lender, rather than having to procure an investor for every individual loan, now packages a number of loans in a mortgage pool. Investors need not consider the merits of the individual loans themselves, or even know anything about mortgages, but rely instead on the proven track record of the GNMA security.

The future of the mortgage finance delivery system is heavily clouded by uncertainty. The thrift industry is undergoing unprecedented difficulties, which undermine its capacity to provide long-term financing for mortgages. Fundamental changes in the future powers of all financial institutions are presently being debated in Congress, and those changes will undoubtedly alter the roles of many institutions that previously have been deeply involved in mortgage finance. As the role of these traditional mortgage finance institutions is altered, the pivotal importance of the secondary mortgage market will increase, because of its ability to attract adequate supplies of mortgage credit from non-traditional, as well as traditional, investors.

Not only is the role of primary lending undergoing radical changes, but the very nature of the mortgage, itself, is being altered. With the inflationary atmosphere and volatile interest rates of the recent past, investors are less willing to lock their funds into long-term fixed rate instruments. The proliferation of creative mortgage financing techniques precludes standardization of the underlying mortgage instruments--a feature that is essential whenever loans are to be pooled and sold in packages as securities in the secondary mortgage market.

The GNMA-MBS is one of the most significant and successful mechanisms ever derived for attracting capital for mortgage investments. MBA believes that the continued strength of the GNMA-MBS program will assist rather than impede the development of a viable conventional MBS market, because trading in the GNMA-MBS serves to establish a benchmark for the pricing of these instruments, as well as serving as a model for the development of a conventional MBS in a market that is currently undergoing radical changes. These fundamental changes inhibit the standardization that is so necessary to investor acceptance of these types of instruments, and may retard the development of an acceptable conventional MBS format.

In summary, the actuarially sound FHA mortgage insurance programs and the GNMA-MBS guaranty program were created to foster support for homeownership and assure access to the credit markets. These programs are remarkably successful at achieving these goals, at no cost to the Treasury. However, the task is not yet finished. The 1980s represent a clear challenge to the housing and mortgage finance industries to deliver adequate supplies of affordable mortgage credit to unprecedented numbers of potential homeowners. The FHA and GNMA-MBS programs will help to address those needs efficiently, unless credit budget ceilings restrict their operations. This Congress will make the decision whether this Nation's commitment to housing its citizens remains one of its important goals.

Economic Prospects

The low level of housing construction of the past two years has been a disaster for the homebuilding industry. It also represents a disaster for the consumer. Most estimates of population and household formation rates envision increasing housing demand during the

1980s. While the general population will increase by 21 million people in the next decade, the population of the prime first-time home buying group, those between 25 and 34 years, will grow by nine million persons by 1990. This is a growth rate three times faster than overall population growth. Many analysts foresee housing demand in excess of 2.0 million housing starts per year for the next decade.

This shortage of housing in the face of strong potential demand will cause a continuation of the upward spiral of home prices and housing affordability problems. The lack of affordability due to rising land and construction costs and continued high interest rates is already posing significant problems to potential homebuyers, therefore, any attempt to restrict access to financial markets will prove disastrous to the Nation's housing market.

Federal Housing Administration

In 1934, FHA initiated the concept of the amortized, even-payment home mortgage loan backed by mortgage insurance in the event of default (see Exhibit 1, which provides greater detail on the FHA programs, including default and loss procedures). Prior to the development of the mortgage insurance concept, mortgage lenders had required large downpayments to secure the property and balance the risk, and demanded lump sum "balloon" payments at specified, short-term intervals. FHA, by pooling the risks of any individual loan across a large group of loans, was able to reduce the potential cost of risk-taking with mortgage insurance. MBA strongly supports the role of FHA, which, in a working partnership between the government and private enterprise, has successfully delivered housing and mortgage finance to American families for nearly fifty years.

FHA became successful while, at the same time, not draining Federal resources by involving the private sector to the largest extent possible. It is the private lender who provides the mortgage funds to the borrower, while the loan is insured by FHA. The government becomes involved only if the borrower defaults on the loan, in which case the lender is reimbursed for losses from reserve funds that are sustained completely by monthly insurance premiums, that is, user-fees paid by borrowers (see Exhibit 2).

The problems of housing America are tremendous and require many different institutions and functions. The rise of conventional mortgage insurance during the 1960s, development of the secondary market for GNMA and, more recently, for conventional loans during the 1970s, and the current development of alternative mortgage instruments illustrate the dynamic nature of the mortgage market. In all of these evolving areas, no institution stands in a stronger leadership role than the FHA. Groundwork prepared by FHA led to development of standardized documentation, uniform underwriting standards and appraisal techniques, as well as the pattern for, and acceptability of, mortgage default insurance. The FHA has led the way in development of a product with enough uniformity to allow the secondary mortgage market to grow to the point of becoming the major source of residential financing today. FHA continues to lead the development of mortgage finance, as witnessed by its successful introduction of the Section 245 graduated payment mortgage (GPM) and the Title I mobile home program as a means of aiding the young, first-time homebuyer in the areas of homeownership and affordability.

The actuarially sound FHA programs do not involve any subsidy. The maximum interest rate on an FHA loan is determined by the HUD Secretary, not the free market. Although the HUD Secretary is under a Congressional direction to follow the free market closely, in actuality, the FHA rate often lags behind changes in the free market rate being charged on conventional loans. When this occurs, and interest rates are rising, FHA lenders charge "discount points" in order to bring FHA loans up to market yield requirements. A point is one percent of the mortgage amount. Therefore, although it may appear on its face as if the FHA loan has a preferential interest rate or enjoys some form of indirect subsidy, this is simply not true, as the following Table 1 illustrates.

Table 1

Comparative Mortgage Interest Rates to Homebuyers[1]

Year	FHA Loans	Conventional Loans[2]
1972	7.53	7.67
1973	8.19	8.26
1974	9.55	9.25
1975	9.20	9.13
1976	8.82	9.02
1977	8.68	8.97
1978	9.70	9.73
1979	10.88	11.12
1980	13.42	13.93
1981	16.11	16.37

1. HUD monthly survey of market conditions; yield to investor in the secondary market
2. Average for new and existing homes

The minimum downpayment requirement for an FHA loan is three percent of the first $25,000 and five percent of the balance. The minimum downpayment requirement for a conventional loan is not a standardized, constant figure, but is determined by the individual lender, not the mortgage insurer. When mortgage investment sources are plentiful, downpayment requirements range as low as five percent. In such a market, conventional loans are more attractive to consumers, because the mortgage insurance premiums will be less than FHA premiums, and the interest rates are likely to be comparable.

When there are insufficient or restricted sources of mortgage funds, however, there is a tendency for conventional lenders to increase the downpayment requirement to as much as 20-30 percent, in order to ration available supplies of mortgage funds. Lenders simply stretch available sources of funds, while also according a preference to loans that will carry a lower loan-to-value ratio, and therefore a lesser risk. Under such conditions, it is usually buyers of lower-priced homes that are rationed out of the market, because of their inability to meet the harsher terms required by conventional lenders. Because maximum FHA mortgage amounts are limited by statute, and these maximum mortgage amounts are set at the lower end of the price scale, the FHA programs are directed toward that part of the market having the greatest need in periods of tight money.

During economic downturns, when mortgage credit availability is restricted, the consumer, especially the first time homebuyer, has little choice but to rely much more heavily upon the availability of FHA-insured mortgages. When low downpayment conventional mortgage loans are sufficiently available, consumers tend to prefer the more attractive terms that conventional loans with private mortgage insurance can offer. Historically, however, the amount of FHA mortgage insurance written has increased significantly during periods of tight mortgage money, and decreased when mortgage credit availability increased.

Government National Mortgage Association

GNMA was established in 1968, and its Mortgage-Backed Security (MBS) program was initiated at that time to introduce alternative sources of capital investment into the secondary mortgage markets (see Exhibit 3). Lenders, who originate mortgages, quite often sell these loans to secondary market investors, rather than holding the mortgages themselves as long-term portfolio investments. This allows lenders in credit short areas to place their loans in the long-term capital markets, so that the lenders can reinvest their limited capital in additional local mortgages. Mortgage finance now depends upon the accessibility of the nationwide secondary market. GNMA's MBS program has helped to foster the secondary market and mobilize money on a nationwide basis, while providing the necessary assurance for investment in mortgages.

The creation of the GNMA-MBS revolutionized mortgage finance by providing a highly liquid, securitized instrument, which attracted traditional and non-traditional investors alike, as illustrated by the following.

Table 2
Distribution of Holdings of GNMA Securities
(dollars in billions)

INVESTORS GROUPS		INVESTORS GROUPS	
Mutual Savings Banks	$ 11.5	Corporations/Parnerships	$ 7.8
Commercial Banks	6.4	Private Individuals	2.5
Savings & Loan Assoc's	22.8	Credit Unions	2.3
Public Retirement/Pension Funds	11.3	Life Insurance Companies	3.4
		Other Insurance Companies	.5
Private Retirement/Pension Funds	.3	State & Local Govt. Gen. Funds	5.7
Mortgage Bankers	3.0	Fiduciary - Individual	.6
Securities Brokers/Dealers	5.7	Fiduciary - Institutional	.9
Nominees	40.9	Others	.4
		TOTAL	$ 126.0
		Terminated Issues	1.2
		TOTAL ISSUES	$ 127.2

Source: Prepared by the Office of the Secretary GNMA, January 13, 1982.

This instrument has served to stabilize the mortgage finance market throughout economic cycles, as well as to create a truly nationwide secondary market. The standardized format offered by the GNMA-MBS spurred investor interest in mortgages and has attracted capital for mortgage credit.

The GNMA-MBS program involves FHA and VA but not conventional loans. Under the MBS program, lenders package FHA/VA mortgages into "pools" and sell them in the capital markets to permanent investors. GNMA prescribes a standard format for the securities and guarantees the performance of the originator/issuer, who must pay investors in full each month, regardless of whether all funds have been received from homeowners. GNMA charges initial and annual guaranty fees and has always made a profit on its MBS activities (see Exhibit 4).

The GNMA-MBS program does not involve a subsidy to either borrowers, lenders, or investors. Rather, by pooling individualized loans, it simply allows the individual borrower to be treated on the same plane as large corporate or governmental borrowers. The following Table 3 compares the secondary market yields of GNMA securities with long-term corporate and utility bonds. The comparison reveals that the yields on these various investments are on a roughly equivalent plane for the nine year period covered. In fact, the yield on a GNMA security has, on average, been 26 basis points (a basis point is 1/100th of 1 percent) higher than comparable corporate bonds and 32 basis points higher than "AAA" rated utility bonds of a similar maturity. Thus, the GNMA-MBS program ensures that the credit market is open to the middle- and moderate-income homebuyer on the same basis as the large corporation.

Table 3
Market Yields On Long-Term Securities

Year	GNMA Securities[1]	Corporate Bonds[2]	Utility Bonds AAA Rated[3]
1972	7.59	7.59	7.31
1973	8.28	7.89	7.74
1974	9.34	9.42	9.33
1975	9.12	9.51	9.39
1976	8.74	8.59	8.48
1977	8.55	8.20	8.19
1978	9.52	8.20	8.19
1979	10.79	10.05	10.03
1980	13.14	12.77	12.74
1981	15.94	15.47	15.56

---

1. Secondary market yield on GNMA securities plus 0.5 percent paid to GNMA by the issuer of the security (and collected from the borrower) as a fee for servicing and processing.

2. Corporate bond yield, new issues rated Aa, as reported monthly in Business Conditions Digest, Department of Commerce.

3. Utility bond yield, new issues rated AAA, as reported monthly in the Federal Reserve Bulletin, Federal Reserve Board of Governors.

The GNMA-MBS program is now indispensable to the proper functioning of the FHA mortgage insurance and VA home loan guaranty programs, because approximately three-fourths of those loans are placed in GNMA-MBS pools. Also, as thrift institutions are decreasing their level of activity as portfolio lenders, the secondary mortgage market will continue to increase in importance over the next decade, and demand the availability not only of the GNMA-MBS program, but of new types of conventional mortgage-backed securities patterned after the GNMA-MBS program.

FHA and GNMA "Credit Budget" Limitations

Until FY 1981 the non-subsidized, actuarially sound, user-fee supported FHA-insured programs and the GNMA-MBS guaranty program operated as demand programs. For the first time, in FY 1981, and in the FY 1982 budget and appropriations measures, limitations were imposed on the FHA insurance functions and the GNMA-MBS guaranty program. Moreover, as shown below, the Administration has recently proposed further reductions in the FHA and GNMA-MBS credit budget ceilings for FY 82 and FY 83.

	FY 1981	FY 1982	FY 1983 (proposed)
		(in billions of dollars)	
FHA	$34.1	$40.0	$35.0
GNMA-MBS	53.0	68.25	38.4
	+11.0 (supplemental)	(-20.25) (proposed supplemental reduction)	
	64.0		

The GNMA-MBS program was treated as a secondary guaranty program under the "credit budget" because the FHA/VA loans guaranteed under the GNMA-MBS program also carry an individual insurance or guaranty. In this terminology, the FHA/VA programs are referred to as primary loan guaranty programs.

Furthermore, on November 5, 1981, the Administration, by administrative fiat, attempted to restrict the GNMA-MBS to a level of $48 billion in gross commitments for FY 1982, more than $20 billion lower than the Congressionally approved limits. At that time, the Administration did not seek to reduce the levels agreed upon by Congress for the FHA programs. In the Administration's press briefing conducted after the November 5 announcement of the Administration's proposed cuts in loan guaranty programs, Lawrence A. Kudlow, Assistant Director for Economic Policy at the Office of Management and Budget (OMB), claimed that the cuts in loan guaranty programs would "Provide the financial market equivalent of a $20 billion reduction in budget outlays—since loan guarantees are typically converted into direct spending not recorded as part of the official budget." At least insofar as the GNMA-MBS program is concerned, this is simply not the case. Nor would it be true for any of the non-subsidized FHA mortgage insurance programs. These programs rely entirely on private investment capital. None of these loans are repurchased by the Federal Financing Bank, as is the case under a number of other "off-budget" loan programs.

Although the GNMA-MBS is a guaranty program, in the 13 years of its existence, its fee income has always offset its expenses. It has not cost the government a single penny (see Exhibit 4). Additionally, it is a secondary guaranty program. Therefore, a reduction in the program's commitment ceiling would not result in a decrease in the overall supply of credit, unless, and only to the extent that a GNMA commitment ceiling would restrict guaranty loan program activity in the underlying primary programs—the FHA insurance and VA guaranty programs; the Administration claimed not to be cutting the latter. Finally, FHA loans and GNMA-MBS guaranties are not converted into direct Federal spending, but, rather, are financed solely by private investment.

Limitations on the GNMA-MBS program constitute a backdoor approach to restricting not only the FHA programs, but also the VA guaranty program, which is an entitlement program. On average, over 80 percent of single-family FHA loans and over 70 percent of single-family VA loans have been placed in GNMA-MBS pools over the past five years. Should a restrictive GNMA-MBS activity ceiling be approached, lenders originating FHA-insured and VA-guaranteed loans would be forced to discontinue originations for lack of a currently available or foreseeable market under the GNMA-MBS program.

MBA strongly opposed the institution of limitations on the non-subsidized, user-fee supported FHA mortgage insurance and GNMA-MBS programs. The Administration recently withdrew its proposal to phase out the GNMA-MBS program over the next five fiscal years and to reduce FHA's role significantly, pending further study. MBA believes that such a fundamental redirection of these essential mortgage finance programs is beyond the authority of the Executive, and that responsibility for the future direction and strength of these programs lies with Congress. To emasculate these programs by administrative fiat flies in the face of authorization language that clearly indicates that such a decision is within the legislative domain.[1]

If Congress does establish commitment authority limits on these programs, however, such limits should be high enough to allow the programs to respond flexibly to demand, as they were designed, should interest rates decline enough to stimulate the mortgage demand that high interest rates have frustrated in recent years. In this context, MBA suggests that flexibility is an essential ingredient of the enforcement mechanism. The Congressional Budget resolution for FY 1982 contained language expressing the sense of the Congress that the credit budget should be limited through the appropriations process. This offers Congress a sufficient opportunity to enforce the credit budget limits without procedurally restraining the ability of Congress to respond should limitations prove to be restrictive.

The full House Appropriations Committee's report on the FY 1982 HUD-Independent Agencies Appropriations law (PL. 97-101) contained precautionary language, in the event that the limits on the FHA and GNMA-MBS programs were approached, which stated that,

---

[1] Sec. 302 (a) (2) (A) of the National Housing Act states that "The Association [GNMA] shall have succession until dissolved by Act of Congress."

"The Department (HUD) is directed to notify the Committee promptly if it appears the limitation will require a moratorium on commitments." (See H. Rpt. 97-162, p. 7). MBA supports the inclusion of such language in this year's appropriation bill to assure that Congress could take appropriate and timely action should the credit budget limitations be approached.

Furthermore, the Continuing Resolution, H J Res 370, provided in Section 136 that

> "Notwithstanding any other provision of this joint resolution, subject only to the absence of qualified applicants, and within the limits of funds and authority available, the head of each department and agency for which authority to enter into commitments to guarantee or insure is provided for in this joint resolution or H. R. 4034 [the FY 1982 HUD-Independent Agencies Appropriations law, which was signed on December 23, 1981], PL 97-101] shall enter into commitments to guarantee or insure in the full amounts provided for in this joint resolution or other applicable law. 127 Cong. Rec. H9154 (daily ed. December 10, 1981)."

This expresses a clear and incontrovertible intention on the part of Congress to set limits on guaranty and insurance programs, which cannot be reduced by administrative directive. MBA urges that language similar to that provided in Section 136 of H Res 370 be included in the FY 1983 HUD-Independent Agencies Appropriations bill.

Credit Budget Estimates

The Administration, in its justification for limitations on the non-subsidized FHA and GNMA-MBS programs, has stated that these programs "accounted for over 55 percent of the $171 billion of total new commitments issued to guarantee loans by the Federal Government in 1980." (See Additional Details on Budget Savings for FY 1982 Budget Revisions, April 1981, page 185, published by OMB.) However, the gross commitment figures for these two programs are not reliable indicators of actual FHA insurance written and GNMA guarantees issued. There is significant "fallout" in these programs between the commitment stage and the point when FHA insurance is written or GNMA guarantees are issued.

The reason for the wide disparity between commitments and final insurance and guarantees is that these programs are designed to operate flexibly as "market hedges" for borrowers, builders, and lenders. If no other form of mortgage insurance or no other secondary market placement is available, or is available but only on less preferable terms or rates, then a borrower or lender may opt to use the FHA or GNMA-MBS programs, and only then is final insurance written or securities are issued.

Additionally, it should be noted that the figure for GNMA guarantees issued reflects secondary rather than primary guaranty activity. GNMA-MBSs are backed by pools of FHA and VA mortgages. Thus, the dollar volume figure for GNMA-MBSs does not effectively represent additional contingent liabilities for the Federal government, nor does it represent additional Federal activity in the Nation's credit markets above and beyond the totals for FHA-VA loans. The alarms that are being sounded about the Federal Government's overwhelming exposure in the area of mortgage finance are substantially overstating that involvement.

Additionally, MBA is concerned that the ceilings Congress sets, even if they are established at the limits of projected demand, nonetheless may prove insufficient. In a review of the estimates over the past eight years, which are estimated two years in advance of the actual fiscal year, it is evident that these estimates consistently have been understated. This points out the virtual impossibility of accurately trying to estimate interest rates, housing activity, and the possibility of increased FHA mortgage limits accurately two years in advance.

The following data (Table 4) track gross and net commitments, estimated and actual, for the FHA-insured programs and the GNMA-MBS program over the past eight years, and illustrates the uncertainty in this process.

Table 4

LOAN GUARANTEE COMMITMENTS AND LOANS GUARANTEED

(in millions of dollars)

Fiscal Year	Gross FHA Commitments	Net FHA Guaranteed	Gross GNMA Commitments	Net GNMA Issuances
FY 1981 Actual	23,634	17,741	42,150	16,853
FY 1982 BUDGET				
1982 Estimate	44,284	31,840	72,360	31,360
1981 Re-estimate	39,232	25,911	72,000	31,000
1980 Actual	30,585	23,344	63,165	22,996
FY 1981 BUDGET				
1981 Estimate	34,155	24,288	53,000	25,000
1980 Re-estimate	31,514	21,695	47,200	20,500
1979 Actual	33,976	21,081	41,750	22,176
FY 1980 BUDGET				
1980 Estimate	27,705	18,601	16,500	16,500
1979 Re-estimate	24,656	16,450	15,000	15,000
1978 Actual	23,953	14,292	15,194	15,194
FY1979 BUDGET				
1979 Estimate	24,709	18,231	15,500	15,500
1978 Re-estimate	20,262	13,384	16,000	16,000
1977 Actual	19,776	12,929	17,019	17,019
FY 1978 BUDGET				
1978 Estimate	16,095	16,095	10,000	10,000
1977 Re-estimate	11,594	11,594	10,000	10,000
1976 Actual	8,316	8,316	8,999	8,999
FY 1977 BUDGET				
1977 Estimate	15,161	4,905	10,000	10,000
1976 Re-estimate	12,056	6,436	10,000	10,000
1975 Actual	11,221	6,130	5,905	5,905
FY 1976 BUDGET				
1976 Estimate	6,093	7,731	7,500	7,500
1975 Re-estimate	5,102	5,663	5,100	5,100
1974 Actual	5,638	5,712	4,125	4,125

Source: Special Analysis, Federal Budget

Actuarial Soundness and the Self-Supporting Nature of Non-Subsidized FHA Insured and GNMA Guaranteed MBS Programs

Both the non-subsidized FHA mortgage insurance programs and the GNMA-MBS guaranty program operate to assure a constant flow of mortgage credit, especially during credit short periods, at no cost to the Federal government. The FHA Mutual Mortgage Insurance Fund (MMIF) includes the FHA Sections 203, 244, and 245 programs. These are non-subsidized programs that are actuarially sound. That is, program losses and claims do not exceed the mortgage insurance premiums collected from borrowers. According to HUD, these programs, as well as the Section 234 program under the FHA General Insurance Fund, are "actuarially sound by any measure." User fees—the income obtained from mortgage insurance premium payments—cover interest on debentures, losses on acquired properties, as well as administrative costs including, salaries, expenses, overhead, rent, etc.

The MMIF has historically been profitable. The net income is used to build up reserves and to pay "dividends" to borrowers who have successfully paid off their mortgages. According to estimates projected in the FY 1982 Revised Budget compiled by OMB, the Treasury will forego savings totalling $363 million through FY 1986 if program commitment levels are artificially restricted by credit budget ceilings to a constant $35 billion ceiling (see FY 1982 Budget Provisions, dated March 10, 1981, Appendix C, page 149 as follows, $15 million [FY 1982]; $36 million [FY 1983]; $63 million [FY 1984]; $100 million [FY 1985]; $149 million [FY 1986]). These savings result from the investment of the MMIF Reserve Funds, totalling $2.86 billion at the end of FY 1980, in U.S. Government securities. To the extent that the MMIF invests in government securities, the U.S. Treasury limits its borrowings in private capital markets, and thereby pays a lower interest rate on that portion of the Federal debt.

The GNMA-MBS program incurred a negative net income only in 1970, its startup year (see Exhibit 4). Since that time, it has been profitable. Commitment and guaranty user-fees pay operating expenses, including, salaries, rent, overhead, etc.; pay guaranty claims; and are used to establish a substantial reserve fund to cover future losses. The GNMA-MBS Reserve Fund now contains approximately $322 million in reserves. If the GNMA-MBS program is restricted to the proposed levels of $64 billion annually through FY 1986, the Treasury will forego savings, as explained above, totalling $24 million. However, the budget proposal for FY 1983 which seeks a much lower ceiling of $38.4 billion, will have an even greater negative impact on revenue than that projected in last year's budget submission, which detailed these statistics.

Countercyclicality: The Role of FHA and GNMA

While private mortgage insurance is available for conventional mortgages at all times, the history of the conventional mortgage market is replete with cycles of high cost and reduced availability of mortgage funds, due in large part to its dependence on thrift institutions, which are suffering from volatile savings flows. Lack of readily available conventional financing then forces many borrowers into the FHA market on a last resort basis. FHA lending does not suffer as heavily at such times, because of the availability of the GNMA-MBS, which is familiar to and accepted by investors. The FHA and GNMA-MBS programs operate, especially during such times, as a hedge for lenders and builders, who must operate in all economic cycles in order to survive financially. As other private and quasi-governmental institutions develop their respective conventional MBS programs, it is almost certain that the GNMA-MBS program, which has in many respects served as the role model for development of securities to tap the capital markets for mortgage finance, will naturally diminish in importance. But this development will take time, and must occur naturally in order to avoid market disruptions.

Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) are vigorously implementing new conventional MBS programs. FNMA recently announced its new Conventional MBS program. Also, legislation has been introduced (HR 4787, and S 1805), which would authorize the FHLMC to alter its operations to pattern itself after the GNMA-MBS program with the exception that the FHLMC's program would deal only with conventional mortgages. These are long-sought and welcome developments, but there remain a number of problems to resolve in this area. The conventional MBS is a relatively recent innovation, having had a mortgage pool balance of only $1.1 billion at the end of 1978. By the end of 1981's third quarter, the outstanding balance of such pools had grown to over $13 billion versus $104 billion of GNMA-MBS securities outstanding as of the end of 1981. However, the development of these instruments is a complicated process that will require years of evolution and cannot be forced by legislative, regulatory, or administrative mandate.

The chief impediment to private issuance of mortgage-backed securities has been that they are not traded in the capital markets, but must be privately placed. This means that the lender must secure an individual investor on a case-by-case basis. This situation can only be cured by standardizing the conventional securities, and such standardization depends upon originations of a large dollar volume of loans with similar characteristics regarding dollar amount, interest rate, terms, etc. However, the mortgage market today is characterized more by its heterogeneity than its homogeneity. The push toward development of creative financing techniques has fragmented the mortgage market, and this lack of standardization impedes the further development of the conventional MBS instrument. Undoubtedly, these problems will be addressed and resolved over time, as lenders and borrowers choose what types of financing best serve their respective needs. But, an extended experimentation period must occur before a conventional MBS program will be developed to address the entire market.

A necessary requirement for the development of an efficient nationwide market in conventional MBS issuances is that the market be large. Security dealers typically "make the market" in various types of securities. In order for security dealers to incur the necessary start-up costs for developing a market, they must be assured that there will be enough volume in that security to warrant their investment. If the market is relatively small, which occurs when each security possesses different features, the dealers either will not develop the market, or will impose large and possibly prohibitive transaction costs. Therefore, the development of the conventional MBS market is not being delayed because of the growth and success of the GNMA-MBS program, but is being restricted due to the lack of uniformity in the underlying conventional loan market itself. In fact, the GNMA security program makes it more likely that the conventional mortgage-backed security market will develop because it spurs competition.

Currently, the conventional mortgage market is in disarray. Large numbers of thrifts are operating in the red because they must pay savers high short-term rates, while their incomes are dependent on old below-market rate mortgages held as assets. As a result, the thrift industry is focusing on the design of new mortgage instruments that will fluctuate with their costs of funds. They are also diversifying their portfolios by increasing their holdings of assets bearing shorter maturities and selling their new mortgages to investors. However, competition from Treasury debt and inflationary expectations limit the willingness of investors to buy these mortgages.

Until conventional lenders solve their problems, or the secondary market institutions, including FHLMC and FNMA, as well as others, are able to expand their capabilities, it is sophistic to argue that mortgage insurance companies can absorb the FHA activity. The difficulty does not lie with the financial capacity of the mortgage insurance companies—they are able to deliver their product—but they are insurers, not lenders. Conventional lenders and conventional secondary market investors are currently encountering such difficulties that they are unable to provide an affordable, steady stream of mortgage funds.

In the strong markets of 1977 and 1978, FHLMC Participation Certificates (PCs) sold at yields close to, and occasionally lower than GNMA-MBSs. Conventionally insured, five percent downpayment mortgages were available to consumers on equal, and occasionally better terms than FHA-insured mortgages. Unfortunately, this is no longer true. The FHLMC's PC program has not been able to maintain its record of sustained growth. FHLMC sales of PCs during 1980 were $2.4 billion—down from $3.9 billion in 1979, and $5.6 billion in 1978. During 1981, FHLMC PC sales recovered slightly to a total of $3.0 billion--still far below the 1978 and 1979 levels.

It is precisely this continuing cyclical instability of the conventional market that underscores the necessity of preserving the FHA and GNMA-MBS as demand programs, until these problems are resolved. The FHA non-subsidized programs, with the readily available secondary backing of the GNMA-MBS program, serve a vital countercyclical purpose during economic downturns.

As Table 5, following, illustrates, the FHA percentage share of the mortgage markets has expanded during economic downturns (1974-75 and 1979-80) while it has naturally contracted during stronger housing years.

Table 5

CONVENTIONAL LOANS INSURED BY MORTGAGE INSURANCE COMPANIES (MIC), FHA AND VA INSURED AND GUARANTEED LOANS BY UNIT VOLUME/1-4 FAMILY HOUSING

Year	Conventional MIC	FHA*			VA	Total Loans Insured	FHA as % of Total
		New	Existing	Total			
1970	59,384	55,580	247,798	303,378	167,380	530,142	57
1971	163,334	59,133	277,654	336,787	282,145	782,266	43
1972	396,008	58,393	178,323	236,716	353,761	986,485	24
1973	499,895	28,940	109,740	138,680	304,788	943,363	15
1974**	330,646	22,559	130,300	152,859	305,314	788,819	19
1975**	322,204	35,946	192,594	228,540	293,594	844,358	27
1976	450,810	32,128	200,230	232,358	321,586	1,004,754	23
1977	617,398	42,786	246,386	289,172	371,610	1,278,180	22
1978	695,620	40,409	263,056	303,465	352,797	1,351,882	22
1979**	578,111	62,960	368,013	430,973	345,708	1,354,792	32
1980**	392,808	58,964	289,450	348,414	255,631	966,853	35
1981**	268,522p	30,981p	130,687p	161,668p	118,842p	549,032	29

---

*Includes: Sec. 203(b), 234, 244, and 245 (GPM)

**Boldface indicates periods of restricted mortgage credit.

p - Preliminary, 1st 9 months.

Source: HUD, 1979 Statistical Yearbook, Survey of Private Mortgage Insurance Activity, FHA Monthly Report of Operations, Veterans Administration. Prepared by the Mortgage Bankers Association of America, April 1981.

Table 5 also illustrates the growing share of the market that conventional mortgage insurers have pursued and won. But this long term trend contrasts sharply with experience during the last three years, when conventional lenders sharply curtailed lending, in part because the conventional secondary market was unable to accommodate further growth.

MBA believes that the current problems facing the conventional mortgage market can and will be sorted out over the next decade. MBA is working aggressively with other lenders and with the mortgage insurance industry to develop a conventional MBS instrument. New alternative mortgage instruments acceptable to the secondary market will be developed, as will a conventional MBS capable of delivering mortgage finance at affordable rates. In 1978, this day appeared close at hand, but with the intervening difficulties of the past three years, even such financial giants as Bank of America, Merrill Lynch, and the Sears group have had to postpone, or scale back, their secondary market activity, and it will take time to develop investor understanding and acceptance of the new alternative mortgages and the conduits to deliver them.

Mortgage Credit Demand

The disappointing industrial performance of the United States over the past five years is a matter of great concern. A few well known economists have pointed to the "explosion" of mortgage credit, arguing that a key factor in the lack of industrial capital formation is that housing has taken a disproportionately large share of available funds and "crowded out" other investment. A careful examination of Table 7 (see page 29), reveals that it is not mortgage activity that has "crowded out" business borrowing, but large increases in U.S. Treasury borrowing and other categories that are the cause.

The failure of business to reindustralize has many complex causes, but increased mortgage activity is not one of them. The business share of credit demand has strengthened since 1975, even though Government borrowing has expanded. Housing credit has fluctuated, but centered roughly around its 21.5 percent average during the entire post World War II period. While mortgage activity did increase substantially in the late seventies versus the early seventies, both in terms of dollar amount and market share, it merely recaptured its historical share of the market. A bar graph (Table 6) illustrates the expanding and contracting shares of credit demand in various sectors during the past five years.

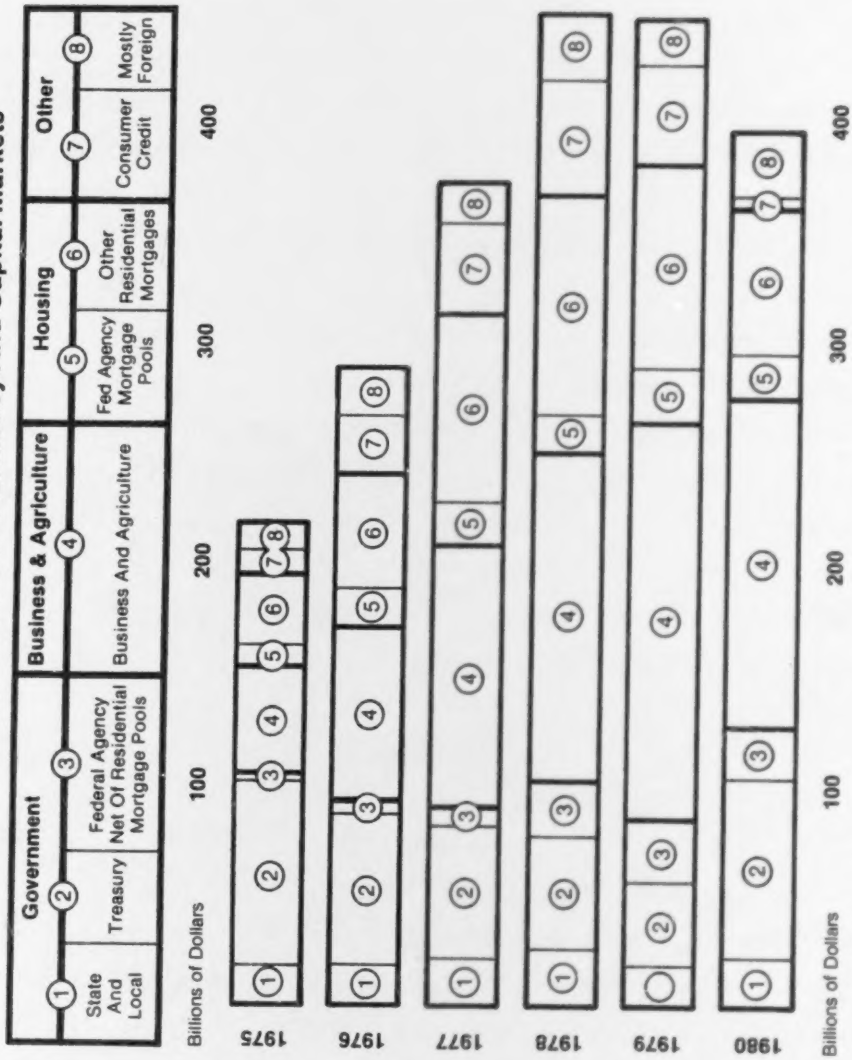
The recovery of mortgage finance in the mid-seventies is not particularly the result of a bias toward homeownership, but rather, results from the maturation of the post-World War II baby boom generation. In view of the strong demographic demands of the past five years, and prospective demand during this decade, housing — far from receiving an unfair share of available funds — must maintain its historical market share, roughly one out of every four investment dollars. Since we have already seen serious shortages of housing finance develop "naturally" in recent years, it is frightening to think what housing activity would be like in the future if Government made a deliberate effort to direct credit away from housing.

SUMMARY

The FHA home loan insurance and GNMA-MBS programs have contributed to a percentage of American homeownership that is among the highest worldwide. By standardizing the markets for mortgage credit, and by allowing borrowers to pool their risks, FHA programs

Table 6

Trends In The Use Of Funds In U.S. Money And Capital Markets



Source: Mortgage Bankers Association of America (April 1981)

Table 7
COMPOSITION OF CREDIT DEMAND
Share of Funds Raised in Credit Markets By Sector

	Total Credit (millions of dollars)	% Business	% U.S. Gov't.	% State & Local	% Consumer	% 1-4 Unit Mortgage	% Other
1950	$28,495	45.5%	-2.7%	11.7%	16.8%	26.3%	2.4%
1951	26,017	52.2	-.8	8.4	6.3	25.0	8.9
1952	35,576	35.8	15.2	10.4	14.8	18.7	5.0
1953	31,833	24.4	22.1	13.4	13.1	23.7	3.3
1954	28,690	28.5	8.3	21.2	5.1	32.5	4.4
1955	44,059	39.8	0.4	12.0	16.2	28.3	3.3
1956	32,471	47.1	-16.4	11.1	12.1	33.2	13.1
1957	34,306	45.0	-2.7	12.4	8.5	25.2	11.5
1958	43,818	29.6	20.4	12.5	1.2	22.3	14.0
1959	61,674	33.0	14.5	10.2	13.0	21.1	8.1
Avg.	$36,694	37.3	7.0	12.1	10.9	25.1	7.6
1960	42,598	40.6	-4.1	12.4	10.2	26.3	14.5
1961	52,993	33.9	14.5	9.6	4.8	23.5	13.8
1962	62,440	35.0	13.4	8.6	10.1	22.6	10.3
1963	68,604	36.6	8.1	8.3	13.0	24.1	9.9
1964	76,422	35.7	8.8	7.9	12.8	22.6	12.3
1965	84,006	42.9	4.6	8.7	12.6	20.4	10.7
1966	80,984	45.5	11.4	7.0	8.1	16.1	12.0
1967	96,466	38.5	13.7	8.1	5.9	13.9	20.0
1968	115,447	39.7	15.1	8.2	10.0	15.0	12.0
1969	126,573	51.9	4.9	7.88	8.5	14.3	12.5
Avg.	$80,653	41.0	9.5	8.4	9.5	18.7	12.9
1970	118,956	44.7	18.3	9.4	4.5	12.1	11.0
1971	169,100	42.1	14.7	10.3	8.7	16.6	7.6
1972	205,000	47.5	7.4	7.2	9.7	20.7	7.6
1973	249,200	49.4	3.3	5.9	9.8	18.6	13.0
1974	230,800	50.6	5.1	7.1	4.3	15.1	17.8
1975	221,500	23.0	38.6	7.3	4.3	17.8	9.0
1976	297,000	29.8	23.2	5.3	8.6	21.5	11.6
1977	388,000	35.9	14.6	5.6	10.4	24.8	8.7
1978	472,300	34.6	11.4	5.5	10.1	23.0	15.4
1979	471,400	37.3	7.9	4.6	9.8	24.1	16.2
Avg.	$282,326	38.2	13.6	6.2	8.6	20.8	12.5
1980	$438,500	36.5	18.1	6.1	0.5	18.6	20.1

The borrowing of Federal Credit Agencies as Residential Mortgage Market intermediaries has been accounted for in the Residential Mortgage category. Other borrowing activity is accounted for in the "other" category along with additional unspecified users of credit.

Source: Flow of Funds Accounts, Federal Reserve Board. Prepared by MBA's Economics Department, January 1982.

have helped this Nation reach for its asserted goal of providing safe, decent, and sanitary housing for all Americans. GNMA programs have fostered an efficient nationwide secondary mortgage market that has attracted non-traditional sources of private financing, and serves as a model for the eventual development of conventional MBS instruments.

MBA shares the concern of the entire Congress over the current inflationary spiral, and the overwhelming disruptive impact of rampant inflation on the American economy. In addressing this problem, and in attempting to set limits on the growth of Federal spending, we believe that all sectors of the economy should carry their fair share of the battle. At the same time, we would point out that in the current inflation fight, a heavy and disproportionate burden has already been imposed on the residential construction and real estate industries, and on this Nation's housing consumers.

Housing programs, with the institution of FHA in 1934 and VA loan programs in 1944, initiated the mortgage insurance concept and for many decades represented the lion's share of the Federal government's contingent liabilities under loan guaranty and insurance programs. This is not true today. Many others have now sought and qualified for Federal aid in the form of loan guaranties (see Exhibit 5). Few, if any, of these enterprises has the track record of actuarial soundness found present in the history of the FHA and VA home loan insurance and guaranty programs. Nor can many of these programs point to the social benefits present in the FHA and VA programs, which have fostered homeownership opportunities and helped approximately 70 percent of American families to own their homes.

The institution of a restrictive credit budget on mortgage finance programs will seriously deter this Nation from continuing to meet its commitment to provide an adequate supply of affordable housing. MBA believes that the imposition of limitations on the FHA and

GNMA-MBS programs will not help to achieve the goal of efficiently coordinating the Government's resource allocation with its fiscal policies and direct expenditures, but rather will decrease the opportunity for, and affordability of, home ownership.

MBA and many other mortgage market participants are working, and will continue to press, for the development of a conventional MBS that will be readily accepted by investors, as well as for the development of new types of mortgage instruments designed to respond to change in all financial markets. FHA and the GNMA-MBS have offered stability in volatile markets and have performed a proper countercyclical purpose in easing housing through difficult economic periods. This simply underscores the importance of a workable secondary market—once a conventional MBS is developed, FHA's and GNMA's role during countercyclical downturns will diminish naturally. Until such time, these programs serve a vital function in stabilizing mortgage finance markets. Until an alternative is developed, it would be unwise to disassemble the one market that does work, and easily responds to demand during economic downturns.

MBA would like to thank the Task Force for providing the opportunity to express our views on this vital issue. We should be pleased to provide additional details for the record.

EXHIBIT 1
FEDERAL HOUSING ADMINISTRATION

The concept of an amortized, even-payment, government-insured home mortgage loan was developed and instituted in 1934 with the creation of FHA's Section 203 home mortgage insurance program. Previously, lenders had required large downpayments with lump sum "balloon" payments at specified, short-term intervals. The Depression wreaked havoc on mortgage markets not only because high levels on unemployment made these large payments impossible with resultant foreclosures, but also because deflation substantially reduced the value of the underlying securities, so the solvency of numerous financial institutions was threatened by high foreclosure rates.

Despite the obvious need to institutionalize a different mortgage form, the private sector not had sufficient experience to determine the actuarial soundness of long-term, evenly amortized mortgages. FHA, by pooling the risks of many individual loans across a large group of loans, was able to reduce the cost of risk-taking with mortgage insurance and still involve the private sector by leveraging private funds with the inducement of a government guaranty. As the FHA gained experience, the amortized, long-term loan ultimately gained widespread acceptance, and FHA's function eventually was copied in the private sector by conventional mortgage insurance companies.

Since its inception in 1934, the FHA has played a major role in assisting American families of low-, moderate-, and middle-income to buy their own homes. It has also functioned to make mortgages easily available and marketable on a nationwide scale. It has played a significant role in making housing opportunities available to families in the inner city. It has furnished strong impetus to the establishment of minimum property standards toward an upgrading of the Nation's housing stock. In addition, it has fostered the development and acceptance of creative financing techniques. Over $229 billion in mortgage insurance has been written by FHA cumulatively through 1979, covering 16 million multi- and single-family units.

There are four FHA insurance funds established to cover losses and administrative expenses incurred under particular programs. Three of the funds were originally designed to be actuarially sound; that is, income generated from the mortgage insurance premium (user fee) is designed to equal or exceed projected losses. The fourth fund was developed to cover higher risk loans, without the explicit intention that the fund be actuarially sound.

MUTUAL MORTGAGE INSURANCE FUND

The Mutual Mortgage Insurance Fund (MMIF) was established in 1934 to provide reserves for the FHA Section 203 home mortgage insurance program. The Section 244 Coinsurance and Section 245 Graduated Payment Mortgage programs were added as recently as 1974 and 1977, respectively. By the end of FY 1981, the MMIF held reserves totalling nearly $2.86 billion. The MMIF is self-sufficient by any measure, and its funds are invested in Treasury bills and thus reduce the cost of borrowing to the Treasury, as well as the Federal credit demand on the private markets. In fact, the FY 1981 revised budget projections for the next five years indicate that if FHA is subjected to a $35 billion constant ceiling the Treasury will forego revenues as follows: $15 million (FY 1982); $36 million (FY 1983); $63 million (FY 1984); $100 million (FY 1985); $149 million (FY 1986).

Mortgage insurance premiums are paid into reserve accounts: one reserve covers losses and the other, a participation reserve account, was established for the payment of dividends. In fact, the MMIF has not only been actuarially sound, but pays participation payments (dividends) to qualifying homeowners upon termination of their mortgages. Additionally, the MMIF covers all administrative expenses connected with the programs it covers, including salaries, rent, and overhead (see Exhibit #2).

COOPERATIVE MANAGEMENT HOUSING INSURANCE FUND

The Cooperative Management Housing Insurance Fund (CMHIF) was instituted in 1965. Currently, it is successfully operating with a positive reserve of $21.2 million generated from payments of mortgage insurance premiums. Like the MMIF, it is user fee supported, and it is designed to be actuarially sound, to cover administrative expenses, and to pay dividends to participating mortgagors, whenever reserve requirements are exceeded.

GENERAL INSURANCE FUND

The General Insurance Fund (GIF) was established in 1965, and is used to insure mortgages under various socially desirable programs, some of which are high-risk insurance programs that might have been placed in the Special Risk Insurance Fund, had it been established at that time. The cumulative deficit of $2.7 billion in the GIF is attributable primarily to the high-risk programs contained in the fund and also to the transfer of GIF moneys into the Special Risk Insurance Fund when it was established. Although the fund was intended to be actuarially sound, the placement of high risk programs in this fund affected that intention, The inclusion of special risk programs, notably the Section 221(d)(3) below market interest rate rental program for low- and moderate-income families, which does not even charge an insurance premium, has diminished the GIF and required the transfer of funds from the MMIF, as well as additional appropriations and Treasury borrowing.

Nonetheless, a number of the programs classified under the GIF have low claims rates evidencing their actuarially sound nature. Otherwise, the major difference between the GIF and the MMIF is that the GIF is not designed to pay dividends to borrowers—it is simply designed to cover losses reasonably projected under its programs and administrative expenses. Like the MMIF, administrative expenses are also to be paid from this fund.

SPECIAL RISK INSURANCE FUND

The Special Risk Insurance Fund (SRIF) was established in 1968. It is intended to provide mortgage insurance for (1) subsidized mortgages for low-income mortgagors, (2) low- and moderate income mortgagors with irregular income patterns or credit histories, and (3) properties located in older, declining urban areas. Originally, the SRIF was funded with a $5 million advance from the GIF, and by 1975 a total of $20 million had been advanced from the GIF. The SRIF has never been, nor was it designed to be, actuarially sound.

The programs it covers, however, are not pure demand programs; rather, they are subject to Congressional appropriations and contract authority limitations. This limits the potential liability of the Treasury and gives the Congress an opportunity to determine annually how large the program should be.

Although the SRIF originally incurred substantial losses, these losses have diminished as programs have been revised. The original Section 235 program, which involved a deep subsidy, has an estimated ultimate claims rate of 21.2 percent with a loss ratio of 47.1

percent; i.e., approximately one-fifth of the loans originated under Section 235 are expected to result in claims, and those claims have resulted in payoffs of nearly one-half of the mortgage balance. That is, while the claim would be submitted for the mortgage balance, once the property was disposed the claim as paid would be reduced significantly.

The revised Section 235 program has an estimated ultimate claims rate of 14 percent, with a loss ratio of 26 percent (see table on page 35 of this Exhibit.) As program experience has developed, losses under the special-risk insurance programs have been cut significantly.

To the extent that the FHA insurance funds have experienced losses, these losses have occurred chiefly in the special risk programs. These programs, however, have social goals, such as revitalization of older, declining urban areas, and provision of housing for high risk borrowers, so financial soundness is relative. Even so, the losses experience have been relatively small when compared with the amount of housing delivered. Also, these programs are already subject to the budget process with annual Congressional appropriation limits and budget reviews.

DEFAULT, FOREBEARANCE, ASSIGNMENT, AND FORECLOSURE PROCEDURES

FHA has established procedures for handling loans in default. A borrower is considered in default when two mortgage payments are in arrears. The lender is required to notify FHA within five working days after a borrower has defaulted. The borrower is also notified about the loan's default status.

The earliest time that a lender may initiate foreclosure is after a FHA borrower has been in default for three months. FHA requires foreclosure to be started within one year of the default or 60 days after the grace period prescribed by state law. Where the property is abandoned, where the borrower has refused further payment in writing, or where the property has been rented, FHA allows for accelerated initiation of foreclosure proceedings so that the value of the security will not be diminished.HUD employs two measures to avoid foreclosure—recasting and assignment. If the default was caused by circumstances beyond the borrower's control, a mortgage cannot be recast unless the lender agrees. The unpaid principal balance of the mortgage may be increased to cover the total unpaid amount and/or the mortgage term can be extended up to ten years without HUD's approval. Where the term will be extended more than ten years, approval is required. Under the assignment program, the lender can assign its interest to the HUD Secretary when the defaulted borrower's situation meets certain specified conditions. MBA has worked closely with HUD in strengthening and improving HUD's procedures for handling problem loans. We have been very pleased with the performance of FHA in this regard.

The following table lists the claims rate determined by taking a class of loans based on 15 to 20 years of experience and further projecting inflation rates to establish an estimated rate for claims in a particular class of loans.

Program	Percentage of Claim Paid After Sale of Security	
	Claim Rate	Loss Ratio
Mutual Mortgage Insurance Fund		
Section 203(b) (Homeownership)	6.9%	51.6%
Section 244 (Coinsurance)	6.9%*	51.6%
Section 245 (Graduated Payment Mortgage)	6.9%*	51.6%
General Insurance Fund		
Section 207 (Multifamily Rental)	22.3%	27.2%
Section 221(d) (2) (Homeownership)	17.2%	75.4%
Section 221 (Market Rate)	33.5%	48.7%
Section 223f (Existing Multifamily)	20.7%	35.0%
Section 234 (Condominium)	6.7%	30.2%
Section 222 (Homeownership, Servicemen)	6.7%	30.4%
Cooperative Mutual Housing Insurance Fund		
Section 213	3.7%	24.8%
Special Risk Insurance Fund		
Section 223(e) (Inner City, Homeownership)	35.4%	98.8%
Section 235i (Original, deep subsidy; Homeownership)	21.2%	47.1%
Section 235 Revised (Homeownership)	14.0%	26.4%
Section 236 (Multifamily)	26.1%	50.6%

Source: Department of HUD, prepared by MBA Legislative Department.

*These figures represent assumptions made for the sake of determining projected actuarial soundness under these programs, because these are new programs.

THE SECURED RISK: CLAIMS RATES AND LOSS RATIOS

A default rate is statistically compiled by HUD on an ongoing, as well as quarterly, basis. This statistic is fairly meaningless because borrowers suffering a temporary setback often reinstate quickly. The ultimate claims rate (See Exhibit 6) is a more telling statistic in determining the government's potential liability, as it represents the percentage of a given group of mortgages that is expected to result in an insurance claim throughout the life of that group of mortgages. However, the claims rate would not reflect all foreclosures, because a foreclosure does not necessariy result in a claim or a loss if the entire mortgage balance is satisfied from proceeds of a foreclosure sale. Loans in default or held in the assignment program do not automatically figure into the claims rate, because a borrower can reinstate.

The loss ratio under a program is a figure estimated and projected for the purpose of determining the actuarial soundness of any particular program. It represents the percentage of a claim that may result in a loss once the claim is paid after the security is sold. The loss ratio and claims rates represent an assumption made for the purpose of analyzing the adequacy of insurance reserves for accounting purposes. These figures are developed from actual program experience; they are projected only where a program is new and has not yet established an experience record.

Thus, as an example, for a group of Section 203 loans originated this year, the ultimate claims rate of 6.9 percent is an assumption that that percentage of loans will be submitted for a claim over the 30-year term of that group of loans. The loss ratio of 51.6 percent means that in the group of loans (6.9 percent) submitted as claims, the final payment would be an average of 51.6 percent of the claims as submitted, or just approximately 3.6 percent of the mortgage amount of the loans originated this year.

In addition, the risk factor of home mortgage insurance is limited because a mortgage by its very nature is secured by a substantial asset—property. Further, inclination diminishes the risk as property values incease beyond the original mortgage balance. Thus, the homeowner-borrower typically is better off selling the house at a profit and paying the mortgage in full rather than losing the house through foreclosure. In brief, the borrower's best interests and those of the government (FHA) are coincident.

EXHIBIT 2

MUTUAL MORTGAGE INSURANCE FUND INCOME STATEMENT: 1950-1980

(Millions of Dollars)

	ANNUAL AVERAGE FOR 5-YEAR PERIODS ENDING:							FISCAL YEARS ENDING:		
	6/55	6/60	6/65	6/70	9/75(1)	9/76	9/77	9/78	9/79	9/80
Fee Revenue	12.0	15.2	21.3	25.5	23.3	21.0	26.4	29.5	33.5	13.6
Premium Revenue	45.8	85.3	153.1	219.0	264.8	245.0	251.8	267.0	299.8	347.0
Investment Revenue	5.3	10.9	18.8	29.6	88.8	116.7	123.8	136.7	147.3	160.8
Other Revenue	.4	.4	12.5	-1.0	.5	-1.1	2.5	5.9	7.4	14.2
Total Revenue	63.5	111.8	205.7	273.1	377.5	381.7	404.4	439.1	487.9	535.6
Salaries and Expenses	22.2	35.4	55.1	66.5	93.9	110.9	107.7	112.1	117.0	125.1
Interest on Debentures	.4	-.1	17.8	3.5	.3	.2	.2	.2	.2	.2
Loss on Acquired Properties	.1	.9	49.2	92.5	124.3	139.2	123.7	96.5	118.1	81.0
Other Expense	.3	.0	.3	8.5	4.5	11.3	20.1	23.8	28.2	20.8
Total Expense	23.1	36.2	122.4	171.0	223.0	261.7	251.7	232.6	263.4	227.1
Net Before Allowances	40.4	75.6	83.3	102.1	154.5	120.0	152.7	206.5	224.5	308.5
Valuation Allowances	-.2	-2.7	-15.8	7.3	-24.6	21.3	-.1	-18.5	-21.1	-71.1
Net Income	40.3	72.9	67.5	109.3	129.9	141.3	152.6	188.0	203.4	237.4

NOTE (1) Includes Transitional Quarter 7/75-9/75

Source: Derived from HUD published data, March 1981.

EXHIBIT 3

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

GNMA has two programs for marketing FHA and VA loans—the Mortgage-Backed Security (MBS) program and the Tandem Program. Under the MBS program, mortgage originators package FHA/VA mortgages as securities ("Ginnie Maes") and sell them in the capital markets to permanent investors. GNMA prescribes a standard format for the securities and guarantees the performance of the originator/issuer who must pay investors in full each month, regardless of whether all funds have been received from homeowners.

Multifamily and mobile home loans can be sold as "Ginnie Maes," but most securities are backed by single-family mortgages. GNMA charges initial and annual guaranty fees and has always made a profit on its MBS activities. Under the FY 1981 and FY 1982 Concurrent Budget Resolutions, the MBS program was treated as a secondary guaranty program because the FHA and VA loans guaranteed by the GNMA-MBS program also carry Federal insurance or guarantees. In this terminology, the FHA and VA programs are referred to as primary loan guaranty programs.

The GNMA tandem program is quite different. It is not a guaranty program. GNMA purchases mortgages at below-market rates and resells them at a discount to investors. The difference between the purchase and sales price is a housing subsidy for which funds must be authorized and appropriated by the Congress. At the present time, only multifamily projects are eligible for tandem.

The Mortgage-Backed Security Reserve Fund administered by GNMA contains approximately $322 million in reserves to cover $104 billion worth of outstanding securities backed by FHA insured or VA guaranteed loans, the original balances of which total approximately $125 billion. A default by an issuer normally does not result in a loss to GNMA. In fact, losses have occurred only rarely in the history of the GNMA-MBS programs.

EXHIBIT 4

FINANCIAL SUMMARY OF MBS OPERATIONS AND RETAINED EARNINGS

FISCAL YEAR

(Dollars in Thousands)

	1970	1971	1972	1973	1974	1975	1976[a]	1977	1978	1979	1980
Income											
Guarantee Fees	$ 13	$ 829	$2,602	$4,529	$ 6,984	$ 9,705	$18,336	$23,432	$ 32,180	$ 41,132	$ 55,730
Commitment Fees	45	431	426	376	781	1,440	3,254	3,961	3,434	51,32	5,041
Interest Income	-	4	108	340	814	1,518	2,996	3,909	5,897	9,853	16,955
Other	-	1	75	84	104	157	313	605	794	1,095	1,824
Subtotal	58	1,265	3,211	5,329	8,683	12,820	24,899	31,907	42,305	57,212	79,550
Expense											
Operating Expense	89	315	438	513	602	856	1,303	1,382	2,102	2,435	3,046
Guaranty claims	-	-	-	-	352	686	4,734	1,584	1,200	393	1,148
Subtotal	89	315	438	513	954	1,542	6,038	2,966	3,302	2,828	4,194
Net income,	-32	950	2,773	4,816	7,730	11,278	18,862	28,940	39,003	54,385	75,357
Adjustments to prior year net income[b]	-	-	-	-	-	-	+240	-	-116	+72	-915
Net Worth/Retained Earnings[c]	-32	918	3,691	8,507	16,237	27,515	46,617	75,557	114,444	168,901	243,343

Totals may not add due to rounding.

[a] Fifteen month fiscal period includes period from 7/1/76 to 9/30/76 and results from change in government fiscal year.

[b] Includes $880 thousand of advances written off as uncollectable in 1980. The other amounts represent adjustments to costs incurred in previous periods under the contract with FNMA.

[c] Equals cumulative net income.

Note: Advances to defaulted issuers, and repayments of the same, do not flow through expense accounts since they represent a charge against capital. They are presented below for informational purposes.

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Advances	-	-	6	-	66	717	1,466	9,111	5,178	653	4,674
Repaid & Write Offs	-	-	-	-	-	-135	-337	-2,923	-6,492	-4,026	-3,055
Outstanding Balance	-	-	6	6	72	654	1,783	7,971	6,659	3,284	4,903

Source: Derived from HUD published data, March 1981.

EXHIBIT 5
CATEGORIES OF FEDERAL LOAN GUARANTIES

Loan guaranty and insurance programs offered by the Federal government can be broken down into three major categories.* The first category includes actuarially sound programs. These are programs where the insurance premiums or fees charged or the revolving loan funds appropriated cover the basic costs of administering and operating the programs as well as the losses incurred under the programs.

In the housing field, this category includes FHA property improvement loans and loans within the Mutual Mortgage Insurance Fund (MMIF), the Cooperative Management Housing Insurance Fund (CMHIF), guaranteed loans, as well as others. This category would also include GNMA Mortgage-Backed Securities, which are not only guaranteed themselves, but cover FHA and VA loans that carry their own underlying insurance or guaranty. While contingent liability exists under these programs, the likelihood that these programs would result in governmental losses is not borne out by historical experience.

The second category consists of programs that require subsidies because the individuals or firms pose greater than ordinary risks, or because there is a greater probability of default or there is a lack of acceptable collateral. In this category, the government carries a greater risk, because the fees or premiums charged to the borrowers are set below the level necessary to provide for an actuarially sound program.

In addition to this "indirect" form of subsidy, many of these programs may also carry a "direct" subsidy, in the form of a legislatively mandated interest rate reduction. Many of the housing programs in the FHA's General Insurance Fund and the Special Risk Insurance Fund fall into this second class of programs. These housing programs, however, are subject to Congressional reviews, limiting their contract authority.

The third category of programs consists of Federally guaranteed loans to large or "discrete" ventures. These large loans are made to a single borrower (e.g, New York City, Chrysler, Lockheed) or a few borrowers (e.g, Synthetic Fuels Corporation). These loans pose an uncertain contingent liability to the government for several reasons. The class of borrowers is small, the available assets or collateral often may not be easily disposed of in the event of a default, and often these ventures involve new technological processes or uncertain economic enterprises.

Although loans insured or guaranteed under this category have been few, they usually involve large amounts, with the result that a default under even a few of these arrangements could involve heavy financial burdens for the government. Also, these have become increasingly popular recently as financing mechanisms, because insurance and guaranty arrangements do not require budgetary reviews or fiscal outlays. This type of loan, to date, has not been utilized to fund any housing programs for mortgage insurance or loan guaranty.

Source: Congressional Budget Office, *Loan Guarantees: Current Concerns and Alternatives for Control*, August 1978, pp. 10-13.

Senator GORTON. Mr. Story?

STATEMENT OF ROBERT STORY, EXECUTIVE VICE PRESIDENT, SEATTLE MORTGAGE

Mr. STORY. My name is Robert Story. I am executive vice president of Seattle Mortgage in Seattle, Wash. I appreciate the invitation extended to me to appear before you today and express my views on proposed limitations on the actuarially sound Government National Mortgage Association [GNMA] Mortgage-Backed Security [MBS] guaranty program.

The involvement of my company, Seattle Mortgage, with the GNMA-MBS program dates back to the issuance of our first pool in April 1974. Our experience with that program has been positive, illustrating the proven viability of that program. We are a small locally owned mortgage banking company, founded in 1944. Our primary business is the origination, sale and servicing of single-family loans. We operate in the Seattle/ Tacoma/Everett area, and we have some six branches scattered throughout the Puget Sound basin. At present, we service approximately $344 million in mortgages, about 82 percent of which are residential, of which 54 percent, or $150 million, are in GNMA mortgage-backed securities.

INTEREST IN REAL ESTATE INVESTMENTS DECLINE

As indicated, we initially participated in the GNMA-MBS program in April 1974, and since then our involvement has continued to be significant. A brief review of our business prior to the advent of the GNMA-MBS program represents an interesting contrast. At that juncture in 1974, we were servicing loans for six mutual savings banks, five savings and loan associations, eight life insurance companies, and several commercial banks. These investors were scattered over 11 States. None of these firms are now active purchasers of such investments. In fact, only two—a life insurance company and a single commercial bank—are presently interested in any real estate investments whatsoever, and certainly not single-family FHA insured or VA guaranteed loans, or conventional residential loans.

In those days, our mortgage company had to secure a commitment to purchase mortgages by an investor on an individualized basis. These individual investors imposed different standards for underwriting loans, with varying requirements regarding income, loan type, location, et cetera. Loan origination decisions were made that much more difficult because a decision had to be tailored to the differing requirements imposed by these various investors. Each investor had different yield requirements and, of course, any commitments that we sought to secure from a potential investor were subject to that investor's availability of funds for mortgages.

NATIONWIDE SECONDARY MARKET CREATED BY GNMA-MBS PROGRAM

These variegated investor requirements placed severe restraints on our ability to serve adequately all qualified borrowers, especially during periods of tight credit. There can be no comparison with the readily accessible, standardized GNMA market in which we now operate. The GNMA-MBS program provides an easily identified pricing mechanism and has created a truly nationwide secondary market. The securitized GNMA's format enables us to tap investment sources that otherwise would not purchase mortgages, by providing a standardized instrument that is widely accepted and easily traded. The benefits offered by the GNMA-MBS program become more evident when compared with our former operations, which involved the pitfalls of dealing with individual investors, often on a case by case basis.

Even before the current crisis being experienced by the thrift industry, back when they possessed sufficient funds for long-term investments, they, too, had moved increasingly toward investment in GNMA-MBS instruments. This was due to a number of factors, including the GNMA instrument's security, liquidity and the administrative savings inherent in the program's streamlined operations.

With some $94 billion outstanding by year end 1980, the GNMA-MBS program has certainly proven to be the key in creating a viable secondary market for single-family, fixed-rate, long-term mortgages. It is not an exaggeration to state that without the GNMA-MBS program, companies such as ours would not have experienced sufficient growth and profitability to have survived during the last several years of the most difficult economic times that we have seen in our company's history.

GNMA-MBS PROGRAM DOES NOT RELY ON FEDERAL DOLLARS

The GNMA-MBS program has also proven itself to be self-sustaining, as it does not rely on any Federal tax dollars. It has also provided the lending industry with a streamlined, efficient mechanism for tapping the Nation's capital markets. With such a positive track record, it is hard for me to view the proposals to phase out this worthwhile program as anything but a backdoor method of diverting credit away from the hard-pressed housing and mortgage finance industries. While I, as an individual, certainly support the thrust and intent of the President's program for economic recovery, I frankly am at a loss to understand the administration proposals to scale back or wipe out this worthwhile program. The one consensus that is accepted by both Democrats and Republicans is that Federal spending must somehow be curbed. However, this laudable goal will not be served by cutting the GNMA-MBS program, because it does not rely on any Federal dollars, but rather depends solely upon private investment sources for funds.

I would like to thank the chairman for allowing me to present my views to this task force. If there should be any questions, I would be most pleased to furnish any additional information.

Senator **Gorton**. Thank you, Mr. Story.

PREPARED STATEMENT OF ROBERT STORY, EXECUTIVE VICE PRESIDENT, SEATTLE MORTGAGE

Mr. Chairman and Members of the Task Force, my name is Robert Story. I am Executive Vice President of Seattle Mortgage in Seattle, Washington. I appreciate the invitation extended to me to appear before you today and express my views on proposed limitations on the actuarially sound, Government National Mortgage Association (GNMA) Mortgage-Backed Security (MBS) guaranty program.

The involvement of my company, Seattle Mortgage, on the GNMA-MBS program dates back to the issuance of our first pool in April 1974. Our experience with that program has been positive, illustrating the proven viability of that program. We are a small, locally-owned mortgage banking company, founded in 1944. Our primary business is the origination, sale, and servicing of single-family loans. We operate in the Seattle/Tacoma/Everett area, and we have some six branches scattered throughout the Puget Sound Basin. At present, we service approximately $344 million in mortgages, about 82 percent of which are residential, of which 54 percent, or $150 million, are in GNMA mortgage-backed securities.

As indicated, we initially participated in the GNMA-MBS program in April 1974, and since then our involvement has continued to be significant. A brief review of our business prior to the advent of the GNMA-MBS program represents an interesting contrast. At that juncture in 1974, we were servicing loans for six mutual savings banks, five savings and loan associations, eight life insurance companies, and several commercial banks. These investors were scattered over eleven states. None of these firms are now active purchasers of such investments. In fact, only two -- a life insurance company and a single commercial bank -- are presently interested in any real estate investments whatsoever, and certainly not single-family FHA-insured or VA-guaranteed loans.

In those days, our mortgage company had to secure a commitment to purchase mortgages by an investor on an individualized basis. These individual investors imposed different standards for underwriting loans, with varying requirements regarding income, loan type, location, etc. Loan origination decisions were made that much more difficult, because a decision had to be tailored to the differing requirements imposed by these various investors. Each investor had different yield requirements, and of course, any commitments that we sought to secure from a potential investor were subject to that investor's availability of funds for mortgages.

These variegated investor requirements placed severe restraints on our ability to serve adequately all qualified borrowers, especially during periods of tight credit. There can be no comparison with the readily accessible, standardized GNMA market in which we now operate. The GNMA-MBS program provides an easily identified pricing mechanism and has created a truly nationwide secondary market. The securitized GNMAS format enables us to tap investment sources that otherwise would not purchase mortgages, by providing a standardized instrument that is widely accepted and easily traded. The benefits offered by the GNMA-MBS program become more evident when compared with our former operations, which involved the pitfalls of dealing with individual investors, often on a case-by-case basis.

Even before the current crisis being experienced by the thrift industry, back when they possessed sufficient funds for long-term investments, they, too, had moved increasingly toward investment in GNMA-MBS instruments. This was due to a number of factors, including the GNMA instrument's security, liquidity, and the administrative savings inherent in the program's streamlined operations.

With some $94 billion outstanding by year-end 1980, the GNMA-MBS program has certainly proven to be the key in creating a viable secondary market for single-family, fixed-rate, long-term mortgages. It is not an exaggeration to state that without the GNMA-MBS program, companies such as ours would not have experienced sufficient growth and profitability to have survived during the last several years of the most difficult economic times that we have seen in our company's history.

The GNMA-MBS program has also proven itself to be self-sustaining, as it does not rely on any Federal tax dollars. It has also provided the lending industry with a streamlined, efficient mechanism for tapping the Nation's capital markets. With such a positive track record, it is hard for me to view the proposals to phaseout this worthwhile program as anything but a backdoor method of diverting credit away from the hard-pressed housing and mortgage finance industries. While I, as an individual, certainly support the thrust and intent of the President's program for economic recovery, I frankly am at a loss to understand the Administration proposals to scale back or wipe out this worthwhile program. The one consensus that is accepted by both Democrats and Republicans is that Federal spending must, somehow, be curbed. However, this laudable goal will not be served by cutting the GNMA-MBS program, because it does not rely on any Federal dollars, but rather depends solely upon private investment sources for funds.

I would like to thank the Chairman for allowing me to present my views to this Task Force. If there should be any questions, I would be most pleased to furnish any additional information.

Senator GORTON. Mr. Waldo, we will now hear from you.

STATEMENT OF ROBERT L. WALDO, PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA

Mr. WALDO. Mr Chairman, my name is Robert Waldo. I am president of Verex Assurance, Inc., with home offices in Madison, Wis. My company writes mortgage insurance in 50 States, Puerto Rico, and the District of Columbia. I appear here today as president of our industry's trade association, the Mortgage Insurance Companies of America. Of the 15 companies presently writing mortgage insurance, 13 are members of this association, and we represent 98 percent of the private mortgage insurance market.

We are concerned over the proliferation of Federal credit guaranteed programs which are a major factor in the upward pressure on interest rates, and our purpose in this testimony is to urge support for the $35 billion cap on the FHA Mortgage Insurance Authority for the fiscal year 1983.

ALL SECTORS OF HOUSING MARKET ARE DEPRESSED BY HIGH INTEREST RATES

You have already heard testimony, and according to recently submitted budget message, in 1981 direct and guaranteed borrowing combined with Government-sponsored enterprise borrowing absorbed an estimated 40 percent of the total credit raised in the domestic credit market. Between 1975 and 1982, net direct and guaranteed borrowing grew at a 19-percent annual rate. High interest rates have depressed all sectors of the housing market and are paid for by all borrowers, including those obtaining guaranteed loans.

The administration deserves your support in its effort to carefully evaluate the credit needs of the FHA in all quaranteed programs and the establishment of ceilings which are realistic and yet minimize their inflationary impact. Last year, the administration recommended a $35 billion cap on FHA for fiscal 1982, which was characterized by some as tantamount to the death knell of the FHA. And in response to this concern, Congress raised the FHA cap to $40 billion.

$35 BILLION CAP MORE THAN ADEQUATE

However, the current estimate of HUD for fiscal year 1982, as reported in budget documents, indicates that the FHA mortgage insurance commitments for fiscal year 1982 are not likely to exceed $29 billion and its new insurance written will not likely exceed $14.5 billion for all of its programs with about $8.5 billion in the one to four-family unsubsidized area. In our opinion, a $35 billion cap for fiscal year 1983 is more than adequate. Not only from the expected level of business activity but also in light of the administration's plan to redirect the FHA unsubsidized home loan programs to first time home borrowers and to innercities.

Certainly, in considering the administration's proposal, and to cap its insuring authority, the task force must consider the role that mortgage insurers play in the housing finance picture and the industry's capacity to absorb the FHA market.

In our formal statement, we detail some comparisons between the FHA's unsubsidized insurance programs and that of the private mortgage insurers. Let me just recite some of the highlights and some of the comparisons between FHA borrowers and loan profiles but only for the first 6 months of 1981 because the FHA's data for the last 6 months is not yet available.

The 15 private mortgage insurers function through approximately 270 regional underwriting offices. No State is served by less than 4 companies and 30 States are served by 8 or more. We are a highly competitive industry. Our assets aggregate approximately $2 billion, and our financial solidity is based on a contingency reserve which, on an aggregated basis at December 31, 1981, was approximately $1 billion. These reserves are accumulated by contributions of 50 percent of every earned premium dollar into a 10-year reserve which cannot be used for any corporate purpose other than payment of claims, and then only if losses exceed 35 percent of earned premiums, and if the State regulator approves.

RISK CHARACTERISTICS SIMILAR

The risk characteristics of loans insured under the FHA unsubsidized program and the loans insured by a mortgage insurance company are very similar. During the first 6 months of 1981, 36 percent of our insurance involved loans with a 5-percent downpayment. Thirty-three percent of the FHA's loans had downpayments of 5 percent or less. The average downpayment for our industry was 12 percent; for the FHA, 11 percent. Fifty-three percent of our insured mortgages and 59 percent of the FHA's were for less than $50,000. Our average is slightly higher than that of the FHA's, but for two reasons.

First of all, the FHA is subject to a mortgage ceiling. We are not. Second, 35 percent of the mortgages we insure are on new construction where prices are higher than existing housing, while the FHA's percentages for the new homes was 16.7 percent in the first 6 months of 1981.

The FHA is erroneously perceived as a mechanism for low income families. Two percent of the privately insured mortgages in the first 6 months of 1981 involved families earning less than $12,000. The FHA data which breaks at $11,000 shows only 0.4 percent of their activity in this market. Now, obviously there are economic factors which inhibit both the FHA and our industry from deeper penetration of their markets. The FHA is mistakenly assumed by many to be a vital mechanism for low income families. This represents only a small fraction of the FHA's activity, and we fully support the FHA's activity in this market.

However, more than 90 percent of the FHA's market in home mortgage insurance, is identical with the market served by private mortgage insurors and this is the activity which the administration would redirect to first-time home buyers and inner cities. It is argued that the FHA is available throughout housing cycles and therefore must be maintained without a cap, as a countercyclical device. We do not believe that this is a valid argument.

FHA'S ACTIVITY DECLINES THE MOST IN MORTGAGE INDUSTRY

According to the Congressional Budget Office staff study dated November 24, 1981, the decline in private mortgage industry during the 1974–1975 recession was less than the decline of the FHA's activity. In 1981, which is certainly a depressed housing year, the private insurors insured 53,400 mortgages on one- to four-family homes more than the FHA and VA combined. The FHA insured 175,000 mortgages with the VA insuring about 142,000.

Now, the private insurors business was down about 10 percent from 1980. The FHA's activity was down 47.5 percent. The only time that the FHA's activity has run countercyclical to the private industry's was in the last quarter of 1979 and in the first quarter of 1980. When market interest rates exceeded the usury limits in a great many States and since FHA loans were exempt from State usury limits, they could continue to be made even though the FHA rate also exceeded those usury rates and they could even insure low-ratio loans that would not otherwise have required insurance.

With Federal preemption of State laws regarding home mortgage rates in late March 1980, this impediment to conventional lending was removed and the private sector again immediately began insuring and increasing the number of loans while the FHA's business began an immediate decline.

In summary, the private mortgage insurance industry can and should insure any loan that can be insured in the FHA's unsubsidized program. The only valid test for affording government loans insurance is whether the home buyer can economically and adequately be served by the private markets. If he is, then it is highly inappropriate for the Federal Government to extend its assistance through credit guarantees.

We do not believe it is possible to support, by any line of reasoning, an argument that a purchaser of a $100,000 home has the right to Federal assistance when the private market is available to him with a down payment of 5 percent.

It has been indicated in previous testimony that the real value of an FHA loan is its ability to be marketed through the secondary market, through a Ginny Mae certificate. The Ginny Mae program has been in existence since about 1970. It has become an active entrant in the secondary market only since about 1977 or 1978. Prior to that time, there was no need for a conventional mortgage backed security, since about 60 percent of the funds, perhaps more than that, used for housing was provided for through the thrift institutions.

CONVENTIONAL MORTGAGE BACKED SECURITY NEEDED

Now, that mechanism has been disrupted by inflation and it is not going to be restored. We do need to have a conventional mortgage backed security.

The problem with having a Ginny Mae security and a conventional mortgage backed security coexisting is that there is no way that a conventional mortgage backed security can provide a 200-percent security blanket with a Federal Government guarantee. That is essentially what is involved in a Ginny Mae certificate. The underlying loans have 100 percent insurance through the FHA and the Ginny Mae certificate has 100-percent insurance against default on the part of the issuer.

Ginny Mae is not going to serve as a benchmark for the price of a conventional mortgage backed security. Rather, it is going to serve as a benchmark for other government securities.

Right now in the marketplace it is possible to get anywhere from 75 to 200 basis points differential between a Ginny Mae and a 10-year Government bond. Ginny Mae, for all practical purposes, is a Government security, just like a Government bond is a Government security. Our concern is that with an unlimited supply of Ginny Maes, which the investor is going to prefer because it has that Government security behind it, there is no way that a conventional mortgage backed security can develop, can achieve that uniformity which Dr. Riedy says is essential to security or can really get off the ground because investors are going to prefer that Government guarantee. It has been indicated that a substantial amount of the funds for housing will have to come from the capital markets.

We simply cannot rely on the 100-percent guarantee of the Federal Government, through Ginny Mae or the FHA programs to provide that entrance to the secondary market.

In conclusion, Mr. Chairman, we strongly recommend that this task force support the administration's request for a $35 billion cap on the FHA's insuring authority for fiscal year 1983.

We believe that the administration's efforts to redirect the FHA to first time home buyers in inner cities is very much in line with the purpose for which the FHA was created. We believe that the time has come when all reasonable and appropriate measures must be taken to reduce dependence on the Federal programs and to reflect Federal efforts to those who cannot be served by the private sector.

Thank you very much for your invitation to us to appear and we appreciate this opportunity to air our views.

I would be very happy to answer any questions that you may have.

Senator GORTON. Thank you, Mr. Waldo.

PREPARED STATEMENT OF ROBERT L. WALDO, PRESIDENT, MORTGAGE INSURANCE COMPANIES OF AMERICA *

Mr. Chairman and Members of the Task Force:

My name is Robert L. Waldo and I appear before you as President of the Mortgage Insurance Companies of America a trade association of private mortgage insurance companies. Of the fifteen companies presently writing mortgage insurance thirteen are members of this Association. Our members represent a 98% share of the private mortgage insurance market.

I am also President and Chief Operating Officer of Verex Assurance, Inc. with home offices in Madison, Wisconsin. My company writes mortgage insurance in 50 states, Puerto Rico, and the District of Columbia.

---

* The Mortgage Insurance Companies of America is a trade association consisting of thirteen domestic private mortgage insurance companies whose insurance-in-force on December 31, 1981 was $114.3 billion. The national officers of the Association are Robert L. Waldo (President of Verex Assurance, Inc.), Madison, Wisconsin, President; Leon T. Kendall, (President of Mortgage Guaranty Insurance Corporation), Milwaukee, Wisconsin, Vice President; William A. Simpson, (President of Republic Mortgage Insurance Company), Winston-Salem, North Carolina, Secretary; Claude E. Pope, (President of American Mortgage Insurance Company), Raleigh, North Carolina, Treasurer; and John C. Williamson, Washington, D. C., Executive Vice President.

Our purpose in presenting this testimony is to urge support of the Administration's request for $35 billion in mortgage insurance commitment authority for the Federal Housing Administration for FY1983. This level of insurance authority should result in a lesser use of the Government National Mortgage Association, and we have no reason to question the adequacy of the Administration's estimate of $38.5 billion for GNMA for FY1983.

For the current fiscal year, the Administration recommended $35 billion for the FHA's mortgage insurance authority. However, the Senate Budget Committee and subsequently the Congress were persuaded by arguments that this reduced level would be harmful to housing. As a result, this limit was increased to $40 billion. According to HUD's current budget summary, the original request of $35 billion would have been more than adequate, as HUD now estimates that the FY1982 commitment level is not expected to exceed $28.6 billion.

We urge the Task Force to recognize that proliferating Federal loan guarantee programs prevent effective control of government borrowing; and is a major factor in generating upward pressure on interest rates. High interest rates depress all sectors of the housing market and are paid for by all borrowers including those obtaining Federally-guaranteed loans. The Administration deserves your support in its efforts to carefully evaluate the credit needs of FHA and all guarantee programs, and set ceilings which are realistic yet minimize their inflationary impact.

HUD's current request for $35 billion in FHA mortgage insurance authority is adequate; and would help signal those interest groups, that constantly seek greater reliance on federal credit, that they should shift their emphasis to greater reliance upon the private sector.

The Administration is requesting legislation to redirect the FHA's unsubsidized home mortgage insurance programs to first time home buyers, inner cities, and housing on Indian Reservations, primarily because of the increasing role of the private mortgage insurance industry in meeting the needs of moderate income home buyers. Limiting FHA resources to those needing assistance; and thereby place greater reliance upon private insurance will benefit every home buyer.

In considering the adequacy of the FHA's $35 billion cap, note that private insurers insured 50% more mortgages than the FHA in calendar 1981, and the total dollar volume of mortgages insured was $18.7 billion - about half of what the Administration has recommended for the FHA.

The Administration's request for a lower cap on FHA mortgage insurance authority is premised on a desire to redirect FHA's home mortgage unsubsidized insurance authority (about 80% of the agency's activity) to areas of the market not served adequately at this time by the private sector. We strongly urge the Committee not to assume that this redirection will constitute a disruption of the mortgage market at this time when the housing industry is in a recession. The private mortgage insurance industry has the capacity to assume most if not all of the percent FHA home mortgage insurance activities as I will explain in detail later in this statement.

It is not a valid argument to assert that because FHA's mortgage insurance activity is a user-fee program, and even earns money for Treasury, that it represents an appropriate function of government. That argument was valid before the private mortgage insurance industry emerged to play a predominant role in mortgage insurance and at less cost to the homebuyer.

The President was recently quoted in Professional Builder as follows:

> "This administration is dedicated to the belief that FHA should complement private mortgage insurers so that it will provide mortgage insurance to only those home buyers who are not now served or who are unlikely to be served by private mortgage insurers. FHA insurance will be targeted to serve these groups in the future."

We strongly urge that this Task Force and the Congress not impose any restraints on the President's resolve to limit this "business" function of the Federal Government to areas of the market not served by private enterprise.

We believe that the Administration's move to redirect the FHA to first time home buyers and inner cities is a step in the right direction, but only a step. This more limited activity of the FHA will still find that agency competing with private industry for essentially the same market. Thirty-six percent of our insurance in 1981 involved 5% downpayments and these were principally first time home buyers. Thirty-six percent of our insurance in 1981 represented 127,248 first time home buyers; yet in all of the FHA home mortgage insurance programs, the agency in 1981 insured 175,052 mortgages. If two-thirds of these were first time home buyers, our industry assisted more first time home buyers in 1981 than the FHA.

Let me now present some facts about our industry which we believe will assist the Congress in making an informed judgment on this subject.

There are now fifteen companies writing mortgage insurance in what has become a highly competitive industry. Our assets aggregate approximately $2 billion, and our financial solidity is based on a contingency reserve which, on an aggregated basis at December 31, 1981 was approximately $1 billion. These reserves are accumulated by contributions of 50% of every earned premium dollar into a ten year reserve which cannot be withdrawn without the approval of the state regulator and then only if losses exceed 35% of earned premiums.

The risk characteristics of loans insured under the FHA unsubsidized program and loans insured by an MIC are very similar. We insure the risk portion; that is, the top 20% of a 90% mortgage and 25% of a 95% mortgage. Our experience over the past two decades proves that this level of insurance is adequate for protection of both the originator and the secondary market investor.

While premium plans vary among the companies, a popular premium plan involves 1/2 of 1% for the first year of a 90% loan and 1% on a 95% loan. The premium on all loans for the second and subsequent years is 1/4 of 1% on the declining balance, whether the loan is 90% or 95%. While mortgage insurers are legally obligated to renew these policies annually, the lender may cancel the insurance at any time. Generally, the insurance is cancelled when the principal balance reaches 80% of original appraised value. The FHA mortgage insurance premium is 1/2 of 1% for each year and the insurance must be maintained over the life of the loan.

However, I am certain that the Subcommittee wants to look behind this record to ascertain the market which we serve and how it compares with that served by the FHA's unsubsidized programs. A comparison follows, based upon 1981 data, to show current performance between the insuring activities of private mortgage insurers and the basic FHA 203(b) program. Unlike previous years FHA does not have available at present data for the last two quarters of the previous year. Therefore, the following statistics are based on the available FHA and MIC data for the first two quarters of 1981.

During this six months, 36% of our insurance involved 95% loans. The basic FHA program, section 203 in that time involved 33% of loans with a 5% or less downpayment. The average downpayment for our industry was 12%; for FHA section 203, 11%.

In the first half of 1981, 53% of the mortgages we insured were less than $50,000. At the same time, 59% of FHA section 203 mortgages were less than this amount. Our average mortgage in 1981 was $51,640; the FHA's, $44,528. In comparing averages, the Task Force should bear in mind two important facts: (1) private insurers are not subject to any mortgage limit, while the FHA is subject to limits that range from $67,500 to $97,000; and (2) 35% of the mortgage we insure are on higher priced new construction while the FHA's percentage for section 203 new construction during the first two quarters 1981 was 16.7%.

With respect to credit underwriting standards, ours are not materially different from those the FHA applies to its unsubsidized programs. For example, we qualify a family if housing expenses do not exceed 33% of gross income; the FHA uses

35% of net effective income, or income after taxes. While the results of applying a pretax or after tax formula might be significant in individual cases, generally, there is little, if any, difference in the family income requirements to purchase a home under either program.

Invariably, in the dialogue on the issues raised by a probable redirection of the FHA's unsubsidized home mortgage insurance programs, the question emerges as to the extent private insurers serve the urban areas. In 1981, 32% of privately insured mortgages involved homes located in urban areas, 61% in the suburbs and the balance in either rural or resort areas. Under the FHA section 203 program, using HUD's own statistics, in 1981, 55% were located in the urban areas, 42% in suburbs, and 3% rural. However, definition of "urban areas" are not consistent and "urban areas" can be so diverse economically that it is difficult to draw a valid comparison.

We noted that HUD breaks the urban statistics into "core city" and "other urban". In the core city, we note that the FHA's volume here was 2% of total insurance. Unfortunately, I cannot at this time give you comparable statistics from private insurers. I can tell you, however, that the private industry has been active in assisting neighborhood housing service corporations. For example, our industry insured 6,857 mortgages in the revitalization of the Philadelphia urban areas where the loans averaged $17,500 in 1976 to $22,500 in 1980. We are advised by lenders of this Philadelphia Plan that the FHA was only minimally involved.

Private insurers have not penetrated the low income market to any appreciable degree, but neither has the FHA. For example, during the first two quarters of 1981, 2% of the mortgages we insured involved families earning less than $12,000 a year. The FHA 203 program, which breaks at $11,000, shows 0.4% penetration of this low income group using the mortgagor's claimed income which is closest to the "gross income" which we use. These figures, I submit, are not an indictment of either the FHA's unsubsidized program or the private mortgage insurance business. Rather, it is an indication that, due to today's home affordability problem, loans to borrowers below certain income levels cannot be prudently insured in an actuarially sound program. Insured loans for these borrowers can only realistically be provided through a subsidy program which reflects Congressional policy as to application of resources to be devoted to subsidies. However, these facts rebut arguments that the FHA unsubsidized programs, not private mortgage insurers, serve low income families.

All available data demonstrate that the private mortgage insurance industry and the FHA unsubsidized programs serve essentially the same market. We believe, therefore, based on the capacity we have built since the inception of the industry twenty-five years ago, there is now ample justification for consideration of a redirection of FHA's unsubsidized role to areas of the market not served by private enterprise. Our industry was created on the experience of the FHA, and our success is a testimonial to the contribution made by this agency since its inception 48 years ago.

Earlier I stated that our industry has the capacity to absorb the FHA unsubsidized home market, and I would like to expand on that point with specific data. In 1979, this industry's unused insurance capacity was $36.8 billion. If the FHA had insured no mortgages that year in its unsubsidized mortgage programs, our industry could have absorbed this market and had $16 billion of unused authority remaining. As of December 31, 1980, our unused insurance capacity was $47 billion. I am attaching, as an appendix to this statement, a table showing how the industry insuring capacity is computed. 1981 statistics will not be available for another month.

It is argued that the FHA is available throughout the business cycle and therefore must be maintained without any cap, as a contracyclical device. This is not a valid argument. Every month for several years, with the exception of the first two months of 1980, when FHA reaped the benefit of its exemption from state usury laws, private mortgage insurers have insured more mortgages than the FHA. Even during the 1973-75 recession our industry insured more home mortgages than the FHA.

According to a Congressional Staff Study dated November 24, 1981 comparing FHA section 203(b) with private insurance, CBO noted as follows:

> "FHA-insured mortgages outstanding declined during the 1973-75 recession, while MIC mortgages outstanding grew, but at a slower rate than during the rest of the decade."

In 1981, certainly a depresssed housing year, private mortgage insurers insured 353,466 mortgages on 1- to 4-family homes, more than FHA (175,052) and the VA (142,180) combined.

There is therefore no basis to the assertion that the FHA functions as a counter-cyclical mechanism and is therefore justified in competing aggressively for the same market as that served by private insurers.

It is alleged that as the residential mortgage market deteriorates, lenders pull back and reduce their volumes of high-ratio loans suggesting FHA is able to serve more first time homebuyers and others needing low downpayment terms in such periods. Yet in 1981, we continue to insure 15% or more of all mortgage originations, consistent with our experience of the past five years, and significantly, 36% of the mortgages we insured represented 5% downpayments, the highest percentage of such 5% downpayment loans in the entire decade of the '70's.

In closing, I want to assure the Subcommittee that the private mortgage insurance industry, while only 25 years old, is financially sound and reliable. It achieved its financial strength despite economic adversities which affected the housing and home finance industries -- and, therefore, the private mortgage insurance industry -- in 7 of its 25 years; and it has done so while providing a public service to over 3 million home buyers at a cost less than that required in the comparable government program. We attribute much of our success to the FHA which paved the way for our industry. We are now in essence, fifteen private state-regulated FHAs. We serve substantially the same market. We are taxpaying entities, and if we sustain catastrophic losses, our stockholders, not the Federal taxpayers, will assume the loss. We will concede that so long as we have no economic catastrophe, the FHA unsubsidized programs do not cost the taxpayers any money, but that does not justify a government competing with private enterprise for the same market with essentially the same product.

We also concede that loans with a 100% Federal guarantee will remain preferable to some investors over privately insured loans where only the risk portion - the top 20% or 25% - is covered. However, we believe that 100% Federal guarantee should be used sparingly, to serve areas of the market which private enterprise, for economic reasons, cannot serve adequately. There ought to be a quid pro quo for 100% Federal guarantee. This was the situation in 1934 when the FHA was created and it justifies FHA's role in the '40's, '50's, and the '60's. However, the situation is vastly different in 1982. What compelling social objective is being accomplished today by the FHA which is not performed by private enterprise, to justify the continued intervention of the Federal government with a 100% guarantee? We are now doing the job and we ask only that the FHA redirect its activities to other needy areas such as rental housing, subsidy programs, and programs such as section 223(e) and 237 which are obligations of the Special Risk Insurance Fund.

We believe that a redirection of FHA's competitive activity as the Administration recommends, with a simultaneous reduction in GNMA authority will avoid the crowding-out phenomenon when government and non-government securities seek to tap the same reservoir of capital. Again, this redirection would not be reflected until the fiscal year beginning October 1, 1982. We have no reason to doubt the Administration's recommendation that the $35 billion cap for FHA for fiscal year 1983 is adequate to meet the agency's projected needs.

We thank the Task Force for this opportunity to present our views.

Capacity of the Private Mortgage Insurance Industry to Write Additional Insurance

Capacity to write additional insurance determines the amount of new insurance that can be written at that point in time without adding to existing policyholders reserves. Policyholders reserves are a key estimate and using state insurance commission definitions, are made up of uncommitted contingency reserves and policyholders surplus.

State mortgage guaranty insurance laws prohibit exposure (risk) from exceeding 25 times total policyholders reserves (capital). Using this limit of 25 and multiplying it by total policyholders reserves will provide an accurate estimate of the industry's total risk writing capacity. Private mortgage insurance, however, is used where needed to insure the risk portion of the loan. Typically, policies will cover the top 20 to 25 percent of the principal balance of the loan at origination. Based on industry data, the average risk portion of all loans is approximately 22 percent. Thus, to estimate the loan insuring capacity (expressed in terms of the face amount of the loans) one would multiply the industry risk writing capacity by 4.55 (1 ÷ 0.22).

In the following table, row (1) is the aggregate Policyholders reserves. Row (2) is row (1) multiplied by the statutory limit of 25 and shows total risk writing capacity. Row (3) is the actual risk in force measured for the respective years. To obtain row (4), the excess insuring capacity at that year end point, subtract row (3) from row (2) and then multiply by 4.55. The excess insuring capacity is expressed in terms of the aggregate dollar volume of insured mortgages.

Industry Insuring Capacity (dollars in billions)

	1975	1976	1977	1978	1979	1980[3/]
(1) Policyholders Reserves $	.468	.583	.753	.952	1.132	1.313
(2) Risk Writing Capacity $	11.7	14.6	18.8	23.8	28.3	32.8
(3) Actual Risk in Force[1/] $	8.8	10.6	13.9	17.0	20.2	22.5
(4) Excess (Unused) Insuring Insuring Capacity $	12.6	18.0	22.4	30.9	36.8[2/]	47.0

[1/] Although statutory limit for the risk-to-capital ratio is 25 to 1, MICs operate more conservatively. The actual risk-to-capital ratio over the past 5 years has been approximately 18 to 1.

[2/] For comparison purposes, total volume of mortgages insured by the FHA during fiscal year 1980 was $21.6 billion including single and multi-family, subsidized and unsubsidized.

[3/] Based on preliminary unpublished industry data.

Although the above table shows a significant growth rate of excess capacity, it is important to note that this estimate is unbounded. The industry has substantial ability to create new insurance capacity. Capacity can be created not only by increments from operations (premium and investment income) and from the prepayment and repayment of insured loans, but importantly, can come from the infusion of new capital. This last source is especially revealing when one considers the assets of the holding company, parents of most individual mortgage insurance companies. (See Enclosure A)

Senator **Gorton**. My first question will be for the first two witnesses and will be for reaction to a certain portion of Mr. Waldo's testimony.

The administration, I think following the analysis of Mr. Waldo, believes that Ginny Mae securities have the same impact on credit markets as Treasury securities, because they are both essentially backed by the full faith of the credit of the Federal Government. Do the two of you agree with that proposition?

Dr. **Riedy**. No.

Senator **Gorton**. And what accounts for the difference?

GINNY MAE PROGRAM USES PRIVATE FUNDING ENTIRELY

Dr. **Riedy**. Well, the difference is that the Ginny Mae program with the underlying securities of FHA and VA loans is entirely using private funding. The Ginny Mae is a vehicle for allowing private investors—we lay out the ownership of the Ginny Mae securities in our formal statements—it is a vast array of investors in mortgages in the secondary market. All it does is facilitate the private market to work for a fairly narrow segment of the entire market and it does not have the Federal Government impact of Treasury borrowing in any way, shape or form.

It allows a certain group of potential home owners to obtain mortgage credit and it allows them to compete in the capital market.

Senator **Gorton**. Does it convert capital from a direction in which it would have gone in the absence of such a guarantee?

Dr. **Riedy**. I think the fact that investors and, let us say, the nontraditional investors in particular, because the second largest group of owners would be S&L's who might invest anyhow, but the largest group of investors are called nominees and they might reflect pension funds, that might otherwise choose stocks or bonds.

In that sense, the program is successful in allowing potential homeowners to compete and attract funds that might otherwise have gone to the corporate sector.

Mr. **Story**. I think from our premise as a company active in the generation of real estate loans, it has replaced a market that no longer exists.

In my statement, I mention the number of lenders that we dealt with, none of whom are now capable of making long-term investments.

Without the Ginny Mae program we would not have a market in which we could sell loans and the traditional thrift institutions who initially had made loans for their own portfolio, are also seeking secondary marketing opportunities. So they have become in essence a mortgage banker.

Senator **Gorton**. Mr. Waldo?

CAPITAL MORTGAGES MUST BE CAPPED

Mr. **Waldo**. That is my point. We just have to cap the capital markets The thrift institutions, that used to buy whole loans just cannot do it. Pension funds cannot do that.

There has been—I do not know if it has been cleared up recently, but there has been a serious question as to what authority the pension funds have to invest in a conventional mortgage backed security. There are all kinds of regulations growing around there and I think that has to be cleared up. But certainly I do not believe that the Ginny Mae security offers any better rate to a homeowner than conventional funding does.

As a matter of fact, in the last several auctions of Fanny Mae, the bid price for FHA loans has exceeded the bid price for conventional loans by a few basis points. Even though the FHA rates, for example, is at 16.5 percent, Fanny Mae buys these at an average rate of 17.995 percent, which means that there has to be almost 9 percent discount to the originator when those are sold to Fanny Mae. That money has to come from somewhere. It is not given away by anybody. It is usually added on to the price of the home and so sooner or later the consumer pays for it.

I just cannot see that the Ginny Mae security, per se, makes any more funding available other than the fact that it is a Government security and as a Government security it is attractive to a lot of people who would otherwise buy other types of government securities, for whatever reason.

Senator GORTON. I have more general questions to each of you, starting with the first two witnesses. As you have heard here today and as you know from our previous hearings, many witnesses have testified to us that Federal credit activities make a substantial contribution to high interest rates. It is equally obvious that a large portion of Federal credits consist of credits involving housing. Nonetheless housing is in the worst shape since the end of World War II.

Have some of our solutions become part of the problem is one question I would like you to address yourself to, and secondly, in this myriad of programs, what is the most valuable tool available to the Federal Government to promote at least adequate housing?

DRAMATIC EVOLUTION IN HOUSING MARKET

Dr. RIEDY. Taking the first part of your question, whether some of our solutions have become part of the problem, I do not think so necessarily. I think what we are seeing happening in the Nation's housing market and, Mr. Waldo referred to it, is a dramatic evolution, because of economic conditions, that is forcing the mortgage to becoming a capital market type instrument. In 1977 for example, the savings and loan industry sold more loans than it acquired for the first time ever and in 1980, about half of all loans that were made were sold to another investor. This is going on because—in good part—of the evolution of the savings and loan industry into a different type of animal. We are going through a great deregulation confrontation and they no longer are the major originators and holders of home mortgage loans in the country. They, too, are selling the loans.

I think we are about two-thirds or a little better through the evolutionary process of the thrift industry. Whether they will come out as born again thrifts, I am not quite sure, but I think there will be more originators and sellers of loans than originators and holders of loans.

So part of our solution could be a problem in the sense that the deregulation process for thrifts could cause problems if not properly handled.

Of course, economic conditions are compounding that problem right now. Other than that, however, we do not have a lot in place. We have tax advantages through mortgage deductability; that is one permanent support. We have bad debt provisions for the savings and loan industry but that is changing in the process of deregulation.

So I am not sure there are too many solutions that we have applied. The one that we are facing today, of course, is the Ginny Mae security, and no one disagrees that it is very successful at cushioning the shock of tight money for a certain segment of the housing market.

The problem is on the other side, in that most of our loans are conventional loans and not FHA and VA loans, and those are cyclical and will continue to be.

The question I suppose you have to resolve in your mind is whether or not the existence of Ginny Mae is indeed stymieing the development or encouraging the development of the conventional mortgage backed security market.

ALL WORKING FOR ONE SOLUTION

In a letter from Wall Street dealers to David Stockman, they argued that Ginny Mae was a role model. We feel the same way. We do not find any other lenders arguing for the demise of Ginny Mae or FHA or VA, but we are all working together for the one solution that everyone agrees on, a standardized uniform easily marketable conventional mortgage backed security. Our focus should be there and the Federal Government is helping in a sense of using the Federal Home Loan Mortgage Corporation, which is a Government instrumentality, to develop participation certificates and in new programs that will eventually, along with Fanny Mae's program, give us two viable conventional market security vehicles. The other alternative has been the private sector, such as Bank of America, that have issued perhaps over $1 billion of their own private insured conventional mortgage backed securities. But that only occurred in the boom years and when credit got tight again, the lenders quit making the low-downpayment loans that private mortgage insurance applies to.

So there is nothing there for history, or it is reduced At least, and the only thing left is the FHA and VA in the low-downpayment area and again lenders all cut back on low downpayments so everybody is getting squeezed.

The existence of the FHA and VA programs, with the Ginny Mae, prevents the squeeze on that side of the market, while the conventional market gets squeezed even more.

Mr. STORY. The solution to the artificially low savers' rate, which affected the country as a whole, in essence has become a problem for the lending institutions, because we no longer have that lower mortgage rate available. We as a mortgage banker can live with that. We suggest that private mortgage insurance companies are merely an insuror and they do not have capital to make these mortgages.

The attitude in our company is, "be my guest." If the private sector, as they use the term private sector, provides those funds, we will make those loans. We feel that at this time, when housing is in such dire straits, that the last thing we should do is to, in effect, discard an effective vehicle to tap that private marketplace. It is actuarially sound, it does not cost the taxpayers any money and we do continue to make FHA-VA loans and we can sell them at a better price than we can sell them through the Fanny Mae program.

As Mr. Waldo suggested, the price is higher at this time so we can sell the mortgage backed bonds.

DO NOT ELIMINATE THE PROGRAM THAT IS WORKING

Our feeling is that in these dire times, the last thing we should do is to consider to eliminate the program that in fact is working. That is not to say that we in the industry are not eventually going to see that a conventional mortgage backed security be made available.

Mr. **Waldo**. The FHA insurance 'as an insurance program, does not provide any capital to housing. The only way that it does provide capital to housing is through its marketability through the Ginny Mae program.

Now, one reason, a number of reasons why conventional loans are not marketed as readily through conventional mortgage backed securities, simply involves the registration requirements. A conventional mortgage backed security must go through a registration with the SEC. This is very cumbersome. It probably is getting better now, but it will never be the same as the ability to market a Ginny Mae which requires no registration at all with the SEC. That is a very handy device to have.

I guess I would question whether or not a Ginny Mae is a private-sector investment. Anybody who buys a government bond is a private investor. Government bonds are not sold to government investors; they are sold to private people. Just like Ginny Mae's which are sold to the same institutions.

So I think to that extent, Ginny Mae's do compete with other government securities for the investor's attention.

You asked if the solution has become part of the problem. I guess the solution that I would consider as being part of the problem is the solution of Ginny Mae that was created a number of years ago to provide marketability to a certain segment of loans. That is part of the problem now and, I think, but only to the extent that the presence of government guarantees in the FHA-Ginny Mae securities impede the development of a conventional mortgage backed security. I believe that that presence does impede the development of that conventional mortgage backed security.

You are not going to get investors' attention to working on something that is going to meet their needs, that satisfies everybody's requirements until they know that there is going to be an end to the stream of Ginny Maes coming on board.

SAVINGS MUST BE ENCOURAGED

As to what the government can do to help, I certainly would agree with the other witness' testimony that our savings rate over the last 10, 15 years has been abysmal. We must encourage savings, because through encouraging savings we are going to provide capital for everyone that needs capital and we will reduce the interest rate and in reducing the interest rate, this is going to do more to solving the housing crisis than anything else.

Our problem today, as much as availability of capital, is affordability to the homeowner and I think that is something that this Government simply must address, in encouraging savings to the point where we can form capital, to the point where interest rates can come down.

Dr. **Riedy**. Mr. Chairman, just one point of clarification and a second half of a shorter story.

In terms of the Ginny Maes being treated as government borrowings, like Treasury borrowings, when the Treasury borrows it decides how to spend the money or the Federal Government does. The Ginny Mae program is a passthrough from one group of investors to private borrowers, homeowners. So I think it is totally different. It was made by a consumer and it is not Treasury borrowing at all.

The other part of the problem in the conventional mortgage backed security is the tremendous disarray in the market today. As anybody reading the paper knows, we have ARM's and GPM's and every kind of new instrument that you can think of which are impossible to standardize, to turn into a security, which is what the capital markets require.

Second, because of the degree of tightness of the credit markets, I think the realtors have reported that, overall, half of all sales are created with financing involving the sellers helping to make the loan to the new homebuyer. Those kinds of loans do not fit into the conventional mortgage-backed security market.

This is all going on in a period of severe restraints. I think what will happen with the housing market, and if the housing market ever comes back strongly when rates come down, say to 12 or 13 percent, lenders as a group will find they have to coalesce on one or two types of standardized instruments, the capital markets will accept them. We will have the conventional backed markets that we need. But until we change the timing, that is, have a recovery in housing, we cannot hope for anything but the fragmentation that we have today.

Senator **Gorton**. Thank you all very much for an enlightening discussion or debate. I appreciate having you here.

Next will be Ms. Barrett and Mr. Keeney.

Ms. Barrett, you may start.

STATEMENT OF PATRICIA BARRETT, DIRECTOR OF TRADE POLICY, NATIONAL FOREIGN TRADE COUNCIL

Ms. **Barrett**. I am director of trade policy of the National Foreign Trade Council. The council was established in 1914, and is the oldest and largest private, nonprofit organization exclusively concerned with the expansion of American foreign trade and investment. Council members account for over 70 percent of U.S. exports and over 70 percent of U.S. foreign direct investment.

The Senate Budget Committee's Task Force on Federal Credit is here to address the need to bring Federal budgetary controls to bear on all Government credit and guarantee programs, and to consider various methods by which this might be accomplished.

The National Foreign Trade Council agrees with the task force on the need for such controls, and is here to comment in that context on our experience with the particulars of 1 of the 358 Federal credit and guarantee programs: The Export-Import Bank of the United States, Eximbank.

Eximbank is a wholly owned Government corporation that provides loans, loan guarantees, and insurance to foreign purchasers of U.S. capital goods.

It must provide these programs because its counterparts, the foreign governments of the countries of our major competitors used subsidized export credit competition to win export orders.

GOVERNMENT UNSUCCESSFUL IN STOPPING WASTEFUL PRACTICE

Our Government has tried unsuccessfully for several years to bring an end to this wasteful practice. Recently, one large user of Eximbank credit, the aerospace industry, made a breakthrough that would make financing a neutral element in commercial aircraft product selection, and thus lead to an end to these subsidies. Although this proposal is a step in the right direction, it will take time to get the multilateral acceptance necessary to implement the new system.

Unquestionably, the long-term solution to this problem lies in the divergence of our national savings away from consumption and the financing of public debt, into productive investment such as research and development, modern plant and equipment, investment in technological skills, and retraining our human resources for newer technologies.

In the short term, however, until there are no export credit subsidies abroad, a large and important portion of our otherwise competitive industrial base will be injured by unilateral withdrawal of support from the Eximbank.

In the meantime, the continued availability of direct loans and guarantees to support U.S. capital equipment exports is essential to give creditability to U.S. negotiators. The Europeans must be convinced that the United States will match their subsidized export credits and thus see that continued export credit subsidies are a costly and futile way to try to gain a competitive edge.

Eximbank has been misunderstood and maligned by some as a huge subsidy to big business, largely because of the lengthy debates and misleading publicity surrounding the loan authorization process. This procedure leads the public to believe that annual loan activity ceilings are an appropriation of funds in the year they are authorized. Unlike direct spending, however, Eximbank's loans are repaid with interest, and Eximbank earns fees for the issuance of its guarantees.

EXIMBANK CAN INCUR A COST

Although the Eximbank has historically been self-sustaining and does not receive appropriations, it can incur a cost in times of high interest rates. But that cost is well justified on the basis of: employment considerations, tax and other revenue return, furthermore, of U.S. industrial base in high technology areas, national security considerations.

The National Foreign Trade Council feels that with a more explicit and better organized budgetary accounting treatment accorded Eximbank, there would be less room for misunderstanding in Congress and elsewhere of its mission, and of its true costs and benefits.

There are four important aspects of Eximbank activity which are relevant to decisionmakers who are charged with placing limitations on gross new lending and guarantee authority:

One, gross volume—the gross amount of new loans and guarantees authorized in a given fiscal year;

Two, net volume—the new loans and guarantees issued minus repayments and expirations;

Three, cost—the present value cost of the interest subsidy and the present value cost of expected defaults; and

Four, benefits—to American society.

Of the four categories mentioned, gross and net volume figures are recorded in the spending budget, but they are understood only by those who are highly skilled at reading these numbers. Neither costs nor benefits are currently presented in the spending budget.

To rectify the current deficiencies in the budgetary accounting for Federal credit and guarantee programs including Eximbank, the National Foreign Trade Council recommends:

One, that all "off-budget" credit and guarantee programs be integrated into the Federal budget process, much as Eximbank is.

Two, that a separate credit and guarantee budget be prepared for all programs, not as an official budget, but as an aid to decisionmakers when considering resource allocation within the spending budget.

Three, that this credit budget feature both gross and net new lending and guarantee volume figures in an intelligible way.

Four, that this credit budget numerically and verbally illustrate the real and intangible costs and benefits to the American public of the various programs.

The members of the NFTC do not want to operate with subsidies. However, until we can bring an end to this practice multilaterally, we feel it is extremely important that Eximbank be allowed to continue to neutralize the effects of foreign-subsidized competition. The alternative is to prematurely precipitate the decline of some of our only technologically competitive industries.

A budgetary treatment that will apprise decisionmakers of the costs, benefits and complexities of the Eximbank programs will help dispel the misunderstandings that have served to undermine the best interest of the American public in this realm.

There is one final point that I have, Mr. Chairman, that I did not have in my formal testimony on the crowding out phenomenon.

CROWDING OUT PHENOMENON NOT SIGNIFICANT WITH EXIMBANK

I do not feel that the crowding out phenomenon is significant with the Eximbank for the following reasons. If all governments around the world were to stop subsidizing the financing of exports, foreign purchasers would still buy the equipment. What would happen is the exporters themselves would have to offer the financing to their customers, instead of Eximbank or the Federal Government raising the money it now does to finance exports, you would have a series of triple A and double A rated corporations going to the market, occupying a similar space in the existing pool of capital. The smaller borrowers would continue to be crowded out, that is, given that there is not an increase in our savings rates.

Thank you, Mr.Chairman, for this opportunity to present our views and I would welcome any questions.

Senator GORTON. Thank you, Ms. Barrett.

PREPARED STATEMENT OF PATRICIA BARRETT, DIRECTOR OF TRADE POLICY, NATIONAL FOREIGN TRADE COUNCIL

I am Patricia Barrett, Director of Trade Policy of the National Foreign Trade Council.

Established in 1914, the National Foreign Trade Council is the oldest and largest private, non-profit organization exclusively concerned with the expansion of American foreign trade and investment.

The membership of the Council comprises a broad cross section of American industry. It is made up of more than 650 firms engaged in all important aspects of international trade and investment. Council members account for over 70% of all U.S. exports and over 70% of all U.S. foreign direct private investment.

Although the business of the National Foreign Trade Council does not normally intersect with the majority of the 358 federal credit and guarantee programs in existence today, there is one such set of programs with which we are familiar. With the view that its special problems might be illustrative of other programs, the NFTC is here today to comment on the particulars of the Export-Import Bank of the United States (Eximbank).

We welcome this opportunity to express our views before the Budget Committee's Task Force on Federal Credit. The National Foreign Trade Council commends the Task Force on its effort to bring Congressional budgetary controls to bear on federal lending and guarantee programs. Although Federal credit as a discrete subject does not normally fall within the purview of the NFTC, we are concerned to the extent that federal claims on the credit markets push up the price of and otherwise limit the capital available to the private sector of the economy for productive investment, which, in turn, negatively affects our productivity and thus our ability to compete in markets abroad.

The National Foreign Trade Council believes it appropriate that Congress have at its disposal a mechanism such that all federal credit and guarantee programs may be subject to congressional scrutiny, in such a manner that the costs and benefits of these programs to American society may be weighed and evaluated in a comprehensive and equitable way.

The Export Import Bank

Eximbank, a wholly-owned government corporation, aids U.S. exports by making financial terms internationally competitive through the provision of direct loans, loan guarantees, and insurance.

Eximbank operates a direct loan program, extending a total of $5.4 billion in new commitments in fiscal year 1981.

Additionally, Eximbank operates a guarantee program, which amounted to $7.4 billion of new guarantees in 1981.

Unlike domestically oriented credit programs, the Eximbank has a unique set of problems dictated by the international environment in which it operates. Over the last 10 to 20 years, the Eximbank has had the goal of fostering the export of capital goods. Capital goods, which are usually expensive pieces of heavy equipment, are most often exported as part of a massive project, such as electric power, transportation, petroleum, mining and industrial projects. It takes a number of years for these projects to generate enough money to pay for themselves. For this reason, the buyer of capital equipment, often a foreign government, needs extended payment terms.

The problem is further complicated by the fact that many government borrowers, particularly in developing countries, are operating on a strict debt service budget. They need to know in advance how much the interest is going to cost them over the life of a given loan for every year the loan is outstanding. They therefore demand a fixed rate of interest. They do not necessarily take into account the inflation differential between countries, and the implications for their real borrowing costs. Because of the extreme volatility of interest rates, and the attendant risks, private sector commercial banks around the world have avoided making fixed rate loans of any duration, let alone ten or twenty years.

The vital importance of capital goods exports to their economies, and the resistance of commercial banks to financing these exports, has led industrial country governments to introduce export incentives in the form of export credit guarantees, insurance, and fixed rate, long term financing. The Eximbank, one of many of these similar institutions around the world, has a counterpart in all countries which compete with the U.S. for foreign markets.

Although the Eximbank was initially chartered to operate on a self-sustaining basis, in recognition of increased competition the Congress added in 1971 a provision to the Export Import Bank act that the Eximbank would:

> provide guarantees, insurance and extensions of credit at rates and on terms and other conditions which are competitive with the government-supported rates and terms and other conditions available for the financing of of exports from the principal countries whose exporters compete with United States exporters.

Over a period of several years, the United States and other industrial countries negotiated a "Gentlemen's Agreement" concerning the terms and conditions of export credit. This effort was given impetus by 1974 and 1978 amendments to the Export-Import Bank Act which require that the Eximbank, in cooperation with the export credit agencies of other countries, seek to minimize competition in government-supported export financing.

These negotiations were first concluded in February, 1978 with the publication of an "Arrangement on Guidelines for Officially Support Export Credits." The "Arrangement" remains in effect today, but the minimum fixed interest rates have been renegotiated upward several times. (Although the "Arrangement" does not apply to aircraft, these products are subject to a similar OECD agreement.)

The problem with the Arrangement is that its interest rates are fixed, and the same interest rate applies to all currencies. This type of fixed rate system made more sense in the early days following the demise of the Bretton Woods international monetary system when exchange rates did not gyrate as much as they do today.

This system of fixed minimum interest rates applied universally to all currencies is inequitable for two main reasons:

(1) the market interest rates of exporting countries around the world vary all over the lot. The higher a country's domestic currency market rate of interest is above "arrangement" minimums, the more a country has the "right" to subsidize the financing. Similarly, the lower a country's domestic market interest rate, the less that country is allowed to subsidize the financing.

(2) The "high" interest rate countries have to go deeper into their pockets to subsidize their export financing than do "lower" interest rate countries.

The only equitable system would be for countries to finance their exports at the domestic market rates of interest in their own currency, or at the market rate for whatever currency in which the loan may be denominated.

Since December 1980, the U.S. Government, led by the Treasury Department, has been attempting to negotiate an improved Arrangement, but its success has been limited.

The National Foreign Trade Council's members would like nothing better than to have all governments eliminate the practice of financing capital goods export sales at rates below those available in commercial financial markets.

In this connection, the U.S. Aerospace Industries Association has developed a proposal that would make financing a neutral element in commercial aircraft product selection. The proposed new financial instrument - an International Equipment Trust - would mobilize private long-term capital at market rates and market terms and would eliminate the need for direct government lending to support aircraft exports at subsidized rates. It would also benefit customer airlines by extending the duration of loans to the useful life of the aircraft, thus reducing their annual debt service burden.

Although this proposal is a step in the right direction, any new way to finance capital goods exports without subsidized export credit is likely to take time. In the interim, it is essential that the U.S. Eximbank use its available resources to match export credit terms offered by our European competitors as explicitly authorized by the legislative mandate given to Eximbank by the U.S. Congress. It is equally essential that the U.S. Eximbank not be immobilized by inadequate funding for direct loans.

The continued availability of direct loans and guarantees to support U.S. capital equipment exports until a new system like the IET is in place is necessary in order to give some credibility to U.S. negotiators: the Europeans must be convinced the U.S. will match their subsidized export credits and thus see that continued export credit subsidies for commercial aircraft is a costly and futile way to try to gain a competitive edge.

It is important to understand that the economic benefits flowing from Eximbank's "neutralizing" of foreign subsidies are substantial. A study conducted by the Wharton Econometrics Forecasting Associates, Inc. shows that the U.S. government receives considerably more in tax revenues generated from exports supported by Eximbank than it pays in interest subsidies on those loans. The study demonstrates that for every dollar of interest "subsidy" incurred by the Eximbank, the government can expect to gain nine dollars in social security and other federal, state and local taxes and reductions in unemployment compensation.

The Eximbank generates additional economic activity in the capital goods sector and its huge supplier and contractor network. Without the activity of the Eximbank, more capital goods orders would go to foreign competition, thus depriving the U.S. of this economic activity, and its attendant employment and productivity.

In the manufacture and export of capital goods, the United States has long been a world leader. However, in the last few years, even our technological strongholds have begun to be challenged. Computer and integrated circuit manufacturers estimate that Japanese hardware will soon be neck-and-neck with our own. Our aircraft producers are encountering stiff competition from the government-owned Airbus consortium in Europe. Our machine tool industry is coming under siege. Our comparative advantage in many of these industries is fragile indeed. To make matters worse, many U.S. companies are filling export orders from plants outside the U.S. whenever possible because of more favorable financing.

There are valid reasons to assume that Eximbank activity contributes to the vitality of the U.S. industrial base. Whereas Eximbank direct loans predominantly assist U.S. industries that represent only 6 percent of GNP, they assist industries that represent 25 percent of our manufacturing output and nearly 100 percent of capital goods production. Among those industries whose loans are supported by Eximbank are oil and gas development, nuclear and hydroelectric power, mining equipment, steel-making equipment, telecommunications, construction equipment, aircraft and aerospace, computers and certain types of measuring and controlling instrumentation.

In addition, the industrial activity supported by the Eximbank helps ensure a larger pool of skilled aircraft, nuclear power, steelmaking equipment and machine tool designers and manufacturers. The value of these secondary national security benefits must also be weighed against the costs to American society of maintaining the Eximbank programs.

Unquestionably, the long term solution to this problem lies in the divergence of our national savings away from consumption and the financing of public debt, into productive investment such as research and development, modern plant and equipment, investment in technological skills and retraining our human resources for newer technologies. In addition, creating an economic climate which is more conducive to private savings and investment will diminish the need for private borrowers to seek federal credit assistance.

In the short term, however, until there are no export credit subsidies abroad, a large and important portion of our domestic industrial base will be injured by unilateral withdrawal of support from the Eximbank.

In order for the Eximbank to function in the best interest of America, Congress must be committed to the competitiveness objective until such time as the international practice of government subsidized export finance is discontinued.

In order for Congress to fully appreciate the importance of the competitive objective and of a strong Eximbank, they need a vehicle through which they can scrutinize Eximbank on its merits, with its costs and offsetting benefits, both tangible and intangible, clearly spelled out.

There is a popular misconception that Eximbank is an agency which involves subsidies to business amounting to several billions of dollars per year. The way the Eximbank is currently portrayed in the Federal Budget may be partly responsible for some of the misconceptions about what its operations actually cost.

Budgetary Treatment for Eximbank

Eximbank is somewhat unique among federal credit and guarantee programs, in that it is already "on-budget" and is scrutinized and limited by the Federal government in several ways.

(1) Overall Operating Limits

Overall limits on the amount of loans, guarantees and insurance the Eximbank may have outstanding at one time are established in the Export-Import Act which is amended by Congress from time to time to authorize new levels of total obligations outstanding.

(2) Annual Ceilings

Annual operating and loan ceilings for the Eximbank or the amount of new commitments the Eximbank can make in a given fiscal year, are established through the federal budget process by the President and the OMB. Although not an appropriation, these ceilings are reviewed by the congressional appropriations committees and the Congress establishes statutory ceilings in the annual Foreign Assistance and Related Programs Appropriations Act.

(3) The Federal Financing Bank

Eximbank derives most of its loanable assets from the Federal Financing Bank (FFB), which has been singled out as one of the "culprits" in the explosion of Federal credit.

Within the context of all agencies which obtain funding from the Federal Financing Bank, Eximbank is again unique. The FFB is an "off budget" agency whose budget authority and and outlays are by law excluded from the unified budget totals of the U.S. government. The FFB, however, has in its portfolio four different categories of assets. One of these is "on-budget" agency debt, which consists of loans and securities issued by Federal agencies whose fiscal activities are included in the unified budget totals. There are two such agencies in this category, one of which is the Eximbank.

The problem with the government's budgetary treatment of Eximbank is that it is misleading and confusing. The protracted debates and publicity surrounding the annual loan authorization procedure lead people to believe that the annual loan activity ceilings are an appropriation of funds in the year they are authorized. This is because accounting for Eximbank's Direct lending program has been forced into the framework devised for direct federal spending. Unlike direct spending however, Eximbank's loans are repaid with interest, and Eximbank earns fees for the issuance of its guarantees.

Accounting for direct spending is relatively straightforward. When taxes are raised or money is borrowed to support direct spending, there is no need to distinguish between the flow of resources and the cost of the program.

With credit programs such as Eximbank, however, the problem becomes more complicated and readily lends itself to confusion.

There are four important aspects of Eximbank activity that are relevant to decisionmakers who are charged with placing limitations on gross new lending and guarantee authority:

(1) Gross volume - the gross amount of new loans and guarantees authorized in a given fiscal year.

(2) Net volume - the new loans and guarantees issued minus repayments and expirations.

(3) Cost - the present value cost of the interest subsidy and the present value cost of expected defaults.

(4) Benefit - to American society of maintaining the programs.

Of the four categories mentioned above, gross volume and net volume figures are recorded in the "program schedules" of the spending budget, but they can only be understood by those who are highly skilled in finding these numbers. Neither costs nor benefits are recorded in the spending budget.

To rectify the current deficiencies in the budgetary accounting for federal credit and guarantee programs, including Eximbank, the National Foreign Trade Council recommends:

(1) That all "off-budget" credit and guarantee programs be integrated into the federal budget process, much as is Eximbank.

(2) That a separate credit and guarantee budget be prepared for all programs, not as an official budget, but as an aid to decisionmakers when considering resource allocation within the spending budget.

(3) That this credit budget would feature both "gross volume" and "net volume" figures in an intelligible way.

(4) That this credit budget numerically and verbally illustrate the real and intangible costs and benefits to the American public of the various programs, in a standard reporting format.

We would like to urge that this Task Force recommend modification of the Federal Budget Presentation of Eximbank's programs, such that decisionmakers will be able to recognize immediately that Eximbank is an entity with income as well as outflows, and repayments as well as borrowings, and that its real cost to taxpayers is not as large as it is made to seem under current budgetary treatment.

In its consideration of alternate budgetary treatment for federal credit and guarantee programs, we do not feel that Eximbank programs should be placed within a stand-alone credit or guarantee budget, removed from the spending budget.

We cannot envision, for example, the inclusion under one category of such diverse programs as mortgage purchase activity (GNMA), mortgage credit (FHA), housing for the elderly and the handicapped, rural housing, Farmers Home Administration, Small Business Administration, disaster loans, student loans, law enforcement assistance, synthetic fuels promotion, highways and mass transit, veterans benefits and services and Eximbank.

Whereas the NFTC believes that there may be some merit in a separate credit and guarantee budget to help Congress and the public fully understand the dimensions of various Federal credit and guarantee programs within the economy, we caution that with Eximbank's unique international problems, the interests of the American public might not be best served by removing Eximbank from the spending budget and placing it instead in any official credit budget.

Senator GORTON. Next, Mr. Keeney.

STATEMENT OF CECIL M. KEENEY, CHAIRMAN, COMMITTEE FOR TITLE XI VESSEL FINANCING

Mr. KEENEY. Mr. Chairman, I am Cecil Keeney, President of Trinity Marine Marketing, Inc., the marketing organization for Equitable Shipyards, New Orleans, La., and Ingalls Shipyards, Decatur, Ala., and Bainbridge, Ga. I am here in my capacity as chairman of the board of the committee for title XI vessel financing.

Our committee represents the entire spectrum of the U.S. maritime industry. Our primary concern is the historically successful financing guarantee program under title XI of the Merchant Marine Act, 1936. I am accompanied here today by Mr. Tim Parke, Jr., vice president of Parker Towing, Tuscaloosa, Ala., and vice president of our committee, and Mr. Thomas Mills, counsel to our committee.

We thank you for the opportunity to testify here today. My oral statement will be relatively brief. I have previously submitted a more comprehensive written statement, together with an economic study prepared by Temple, Barker & Sloane, which I ask be included in the record.

Senator GORTON. It will be included in the record in full.[1]

Mr. KEENEY. Thank you, Mr. Chairman.

PROGRAMMATIC CONTROLS OF FEDERAL CREDIT ASSISTANCE PROGRAMS NEEDED

As users of bond market credit, we are vitally interested in the availability and costs of credit, and the aggregate Federal involvement in the credit market, whether by direct borrowing or by federally sponsored programs. While it appears to us that the real problem is with the size of direct borrowings by Treasury, we agree with Messrs. Kudlow and Mehle from the administration and Mr. Greenspan who testified yesterday concerning the need for programmatic controls of Federal credit assistance programs.

Treasury Secretary Donald Regan and others have articulated the following problems with Federal credit assistance programs: The administrative expenses in running the programs which are paid for out of the Treasury; direct budgetary outlays in terms of interest rate subsidies and payments of defaults; and "distortion" of U.S. credit markets.

We agree that credit assistance programs pose these problems and think that each program ought to be measured using these problems as criteria. Moreover we think additional, more stringent criteria should be included such as: contribution to capital formation, positive economic benefits, contribution to employment, and contribution to national defense.

We agree with the concept of programmatic control of Federal credit assistance programs. We do not agree with the indiscriminate approach of lumping all loan guarantee programs together. Indeed, that is contrary to the "programmatic controls" suggested by the administration's witnesses. We are particularly concerned with OMB's unilateral action, independent of Congress, drastically cutting title XI loan guarantees without having first established an overall programmatic framework for managing Federal credit programs.

---

[1] See p. 301.

Unfortunately, the administration has not applied such criteria to the title XI program. If the criteria above were to be applied to the title XI program, the results would show the following:

ADMINISTRATIVE EXPENSE

All the administrative costs are paid for buy users of the program. Last year, administrative expense was under $4 million. User fees were approximately $48 million, leaving a net surplus of $44 million. The total accumulated surplus from title XI is now over $250 million and projected to be $360 million by the end of fiscal year 1983.

DIRECT BUDGETARY OUTLAYS

All title XI bonds are secured, and all defaults—of which there have been only 11 in the 44-year history of the program for a loss rate of 0.8 percent—have been paid for from the accumulated user fees. There is no outlay for interest subsidy since the Government is only contingently liable and interest rates are in excess of the cost of money to the Treasury. The program is not run through the Federal Financing Bank and there is no borrowing by the Treasury. In short, there is absolutely no budget impact from title XI financing.

DISTORTION OF THE CREDIT MARKETS

Title XI does not distort the credit markets—it does not "crowd out" investment in capital equipment. It is investment in capital equipment. As Mr. Greenspan testified here yesterday, there is an enormous difference between a direct dollar outlay—such as occurs when the Federal Financing Bank is involved in purchasing agency obligations—and Federal guarantees of mortgage-backed obligations. Title XI is the latter—a Federal guarantee of a private mortgage-backed obligation for capital equipment. This financing is sensitive to interest rates.

CONTRIBUTION TO CAPITAL FORMATION

Title XI provides a positive incentive for capital formation. Users of title XI must invest from 25 percent to 40 percent of the total capital cost of the project and place that amount at risk before the Maritime Administration issues a guarantee.

PROVIDES ECONOMIC BENEFITS AND JOBS

Each title XI guaranteed dollar generates $4.70 in revenues throughout the economy and the program generates 99,000 jobs annually. Most of that revenue and those jobs would be lost without title XI and, that would have a direct negative budgetary consequence. Tax revenues are being lost and Government expenditures for unemployment are being incurred by the unilateral action of OMB.

CONTRIBUTION TO THE NATIONAL DEFENSE

Title XI is absolutely vital to the national defense in two ways:

One, it supports the naval shipbuilding base—at no cost to the public—and actually saves the Navy money by absorbing shipyard overhead and keeping skilled shipyard work forces intact in times—like these—when no significant naval shipbuilding is occurring.

Two, it builds ships which are themselves vital to the Navy as naval auxiliaries. For example, 34 ships presently under charter to the Military Sealift Command were built with title XI.

Shipbuilding is a highly capital-intensive, long leadtime industry. It takes 2 to 3 years minimum from the time a decision to build a ship is made and a ship is delivered. Long-term financial planning requires certainty. The traditional title XI authorization process whereby the authorizing committees have adjusted the statutory ceiling at approximately 3-year intervals has worked well.

Within the authorization level, the market for capital equipment has set annual limitations. Annual oversight by the authorizing committees of Congress provides additional control.

Administrative limitations that have been imposed unilaterally by OMB have been disruptive and counterproductive. Since the program has had only positive economic and budgetary consequences and cutbacks in the programs have immediate adverse economic and budgetary consequences, we see no justification to subject title XI to arbitrary, across-the-board cuts. Annual budget-type authorizations do not mesh with the long lead times characteristic of the shipbuilding industry. We ask you to keep such things in mind in recommending a mechanism for controlling Federal credit assistance programs.

In summary, we concur with the need for credit budget controls and for "programmatic" evaluation of each credit program. In fact, we urgently solicit such an evaluation of title XI ship construction financing. We are confident that such an evaluation will justify support for continuation and expansion of the program.

That concludes my oral statement. We thank you for the opportunity to make our views known. I will be glad to answer any questions you may have.

Senator GORTON. Thank you, Mr. Keeney.

PREPARED STATEMENT OF CECIL M. KEENEY, CHAIRMAN, COMMITTEE FOR TITLE XI VESSEL FINANCING

I am Cecil Keeney, President of Trinity Marine Marketing Inc., the marketing organization for the Equitable Shipyards, New Orleans, Louisiana. I am here in my capacity as Chairman of the Board of the Committee for Title XI Vessel Financing. This Committee represents a cross section of the U.S. maritime industry -- operators of deep-sea vessels, inland operators of tugs and barges, offshore operators of drilling, tug/supply vessels and speciality-construction vessels, large shipyards, small shipyards, labor, and the supply industry serving operators and yards. The Committee's interest is in the historically successful financing guarantee program under Title XI of the Merchant Marine Act, 1936. We thank you for the opportunity to testify here today.

We understand that the major purpose for these hearings is to analyze the economic and budgetary effects of federal participation in the U.S. credit markets. To that end we have been asked specifically to comment on the effect of federal credit programs on market allocation of credit, interest rates, and the current budgetary treatment of credit programs. We are addressing those questions as they relate to and are affected by the new vessel construction financing guarantees under the Title XI program.

It is our view that in analyzing the impact of federal credit programs it would be a mistake to lump all federal direct loan and guarantee programs together. We believe that it makes no more sense to consider all credit assistance programs en masse than it would to consider all appropriations en masse. Each program differs markedly in the way it operates, the statutory goals sought to be achieved, the criteria for qualification and use of a particular credit program, the method by which the loan or guarantee is issued or funded, the degrees of security required and the cost, direct or indirect, to the Federal Treasury.

The reasons articulated by Treasury Secretary Donald Regan and others for cutting back or eliminating Federal credit assistance programs are these: administrative expense in running the programs which is paid out of the Treasury; direct budgetary outlays for interest rate subsidies where the rate is less than the cost of money to the Treasury; payments of defaults which amounts to a deferred subsidy; and "distortion" of the U.S. credit markets by crowding out private borrowers who would otherwise make capital investments.

Perhaps one methodology this Task Force might use to analyze the budgetary impact of Federal credit programs is to measure each individual program against those criteria. At the same time the economic impact of each program should be addressed by the legislative committee having jurisdiction over the program. I believe such an approach would be consistent with that outlined by the Administration's witnesses, Assistant Treasury Secretary Mehle and OMB Assistant Director for Economic Development Kudlow, in their statements before this Task Force on December 10. We would like to apply this approach to the program in which we are vitally interested, the Federal loan guarantee program for financing new vessel construction under Title XI of the Merchant Marine Act. We are submitting for the record as Exhibit A, a memorandum addressing the legislative and operational history of the program and as Exhibit B, a study done by Temple, Barker & Sloane, Inc. of Lexington, Massachusetts on the economic impact of the Title XI program.[1] We would first like to describe briefly how the program works.

In Title XI guaranteed vessel financings, after making the statutory findings of economic feasibility, financial and operating ability, and reaching agreement between the Secretary of Transportation and the vessel owner on the amount of equity investment, preferred mortgages, reserve funds and other security arrangements, the Secretary issues a commitment to guarantee bonds to be issued by the vessel owner. The vessel owner then issues bonds in the private capital markets at the prevailing market rate and bond proceeds are used only for capital equipment. The bonds bear the Government guarantee but there is no borrowing by the Government in connection with the issue of bonds and the Government obligation is contingent only. The statutory authorization for Title XI financing, which the Office of Management and Budget has unilaterally limited by annual ceilings, does not involve appropriated funds but is rather a revolving guarantee authority.

---

[1] See exhibit A, p.427 and exhibit B, p.458

The limit on the amount of guarantees which may be outstanding at any time is specified in the statute and, until the action by the Office of Management and Budget, has never been limited on an annual basis. In practice, however, there is a built-in limitation in that the statutory findings required of the Secretary require that the market for the equipment being financed be carefully analyzed. If the transaction does not meet this market and other stringent tests, no guarantee may be issued irrespective of the statutory level of authorization. Consequently, adjustments in the statutory ceiling have traditionally been made at 2-to-3 year intervals.

Now let us measure the Title XI program against Secretary Regan's criteria:

Administrative Cost: The administrative expenses of Title XI are paid for by users of the program. There are charges for the processing of applications ("investigation fees") and an annual guarantee fee of 1/2 to 1% on the outstanding balance of the guaranteed financing. These user charges pay for all administrative expenses, including office space, salaries of government employees, travel and other overhead. Last year, for example, the administrative expenses of the program ran somewhere between $3 and $4 million. User fees (investigation fees and guarantee fees) amounted to somewhere in the neighborhood of $48 million, leaving a surplus last year alone of over $44 million. The fund currently has a surplus of over $250 million.

Direct Budget Outlays:

(a) Interest rate subsidies. Interest rates for Title XI bonds are determined by the market and are in excess of the rates on direct obligations of the Treasury for comparable securities. Users of Title XI sell notes or bonds with the government guarantee directly in the private credit market. Title XI operates independently of the Federal Financing Bank and there is no direct borrowing by the Treasury.

(b) Defaults. The Government's obligation with respect to Title XI financing is contingent only and drawing against the Treasury could occur only if there are defaults which cannot be covered by the user charges paid into the Ship Financing Fund. In the history of the Title XI program to date there has not been a drawing on the Treasury because of a default under Title XI. There have been some defaults including some potentially large defaults because of the bankruptcies of Pacific Far East Line and States Steamship Line in the mid 70's. Nevertheless, because the government has a first preferred ship mortgage on each vessel in respect of which it guarantees the financing and secondly because of the user funded Title XI Ship Financing Fund, described above, the government has not had to draw on the Treasury to make good on a default.

Over the history of the program, 11 defaults have occurred with a cumulative net loss of only 0.8% of total guarantee commitments extended. On an annual basis, this loss record is extremely low, slightly more than 0.1% of outstanding commitments, and compares favorably with the largest commercial banks on their commercial loans which have a much shorter average maturity than Title XI. Thus, sound program management, a diversified portfolio, prime security interest and self generating reserves have resulted in a program that has cost the U.S. taxpayer nothing while assisting in the building of over 7000 vessels.

Distortion of Credit Market: Title XI also measures well against the last of Secretary Regan's criteria -- the distortion of the credit market. Title XI guarantees accounted for only 1.2% of the total federal loan guarantees, direct loans and federally-insured loans outstanding in 1981, and that is also the average percentage over the last six years. Moreover in FY 1980 Title XI accounted for only 1/400ths of the total direct federal or federally-sponsored borrowings in U.S. credit markets. Its impact on interest rates, therefore, is infinitesimal. An analysis of Title XI guarantee commitments as a share of total funds raised in U.S. credit markets shows that net new Title XI commitments were less than 0.1% or 1/1000th of the total net credit funds raised in 1981, and the proportion of Title XI to the total credit funds raised was 60% lower in the last five years (1976-1981) than in the previous five years (1970-1975). It has not distorted the credit markets therefore because new commitments have accounted for a decreasing percentage of the volume of new credit funds available.

Distortion of the credit market by Federal participation, as we understand it, is considered unhealthy where there are fewer total available funds than are demanded for capital investment in which case those ready and willing to invest in capital equipment may be "crowded out" by direct Treasury borrowings and Federal Credit programs. Since, as shown above, every single Title XI guaranteed dollar is put into capital equipment we see no merit whatever to the "crowding out" argument in the case of Title XI. The users of Title XI financing, which requires considerable equity investment in addition to the guaranteed debt, are in fact the investors in capital equipment who would otherwise be crowded out. One of the great disappointments of the tax cut to date has been the failure of the business community to reinvest the dollars returned to it. No such problem would occur with Title XI, since demand for fully secured Title XI guarantees remains strong, significantly in excess of the statutory authorization and far greater than the amount at which OMB has administratively limited the program to this fiscal year.

Title XI, moreover, rather than disrupting market forces enhances them. The merchant marine industry is highly capital-intensive. Accordingly, entry costs are exceedingly high relative to other industries. Free market forces work better as perfect competition is approached. Title XI enhances competition by facilitating entry.

Allocation of Credit: Title XI gives access to the U.S.long-term bond markets to companies, including smaller independent entrepreneurial companies who are prepared to invest in productive capital equipment and who would not otherwise have such access. If Title XI were eliminated or substantially eroded, as has been the case this past year, either less U.S. shipbuilding would occur -- or large companies with access to the long-term funds market would, to some extent, take up the slack. And much of that building would be transferred abroad. In that case, as we show later, the national defense would be seriously harmed, and positive economic growth stifled. In addition, increased concentration would result in an industry now characterized by small and medium-sized businesses.

The Effect on the Economy: The Temple, Barker & Sloane study shows, in summary, that over 1,190,000 man-years of employment, or an average of 99,000 jobs annually, and $76.6 billion in revenues were generated by the Title XI program during the period FY 1970-1981. For each dollar guaranteed (not borrowed) by the Government under Title XI, a total of $4.70 of revenues is generated throughout virtually every sector of the United States. Three distinct types of positive impacts on the U.S. economy are generated: (a) direct impacts, (b) indirect impacts and (c) induced impacts. Direct impacts, are the wages, other costs and profits plus the materials purchased by shipyards for Title XI shipbuilding. During the period FY 1970-1981, $16.3 billion (in 1981 dollars) and 277,000 man-years of employment were generated by Title XI. Indirect impacts are the goods and services purchased by suppliers to produce materials sold to shipyards and successive rounds of inter-industry purchases. For each dollar of direct revenues another dollar of indirect revenues is generated; for each shipyard employee, another 0.8 jobs are created in the shipyard support/supply industry. During FY 1970-1981, $16.3 billion (in 1981 dollars) in indirect benefits and 220,000 man-years of employment were generated. The combined direct and indirect impact of Title XI during the FY 1970-1981 period was $32.6 billion and 497,000 man-years of employment.

The induced impact represents the results of the wages of direct and indirect employees when spent by their households and then respent throughout the economy. For each dollar of direct and indirect benefit, $2.70 is generated as induced benefit, and for every direct and indirect job created by Title XI another 2.5 jobs are induced by the direct and indirect incomes generated in the economy.

In addition to the positive impacts of Title XI shipbuilding, the ships built under Title XI themselves have significant positive impacts. In 1980, the Title XI fleet generated an estimated $4.8 billion in revenues and employed about 37,000 people ashore and afloat. This beneficial impact continues, moreover, each year for the entire life of the Title XI-built vessels.

Because of the OMB-imposed ceiling on Title XI, TBS estimates that $1.9 billion in current active projects (for which Title XI applications are on file) will be subjected to delay and possible cancellation over the next two years. Half of this business could be placed with foreign yards and operated with foreign crews. This, in turn, could expose more than 31,000 man-years of shipyard labor to lay-off; more than 133,000 jobs throughout the economy to loss; and cost the U.S. economy over $9.1 billion in revenues.

National Defense Implications: The Title XI program is vital to national defense in two distinct respects: it contributes to the maintenance of a shipbuilding and supplier base which is essential for construction of naval vessels; and many of the vessels constructed under the program are available as naval auxiliaries.

Shipyards cannot maintain their work forces and other facilities while waiting for a naval shipbuilding program to come on stream without commercial construction. The Title XI program is essential to commercial construction and cut-backs in Title XI financing, including the elimination of drilling vessels, are threatening the closure of some yards and serious cut-backs in force by others. Without Title XI, these yards will be faced with a loss of skilled employees and depletion of the supplier base needed for naval construction. Some of that has already occurred. While we have not quantified the amounts, we are confident that the unemployment costs associated with shipyard layoffs and closures are significant now and will only get worse without correction of the Title XI problem. These costs are not contingent, they are real, and have direct adverse budgetary and economic impacts.

One might note that OMB's press release accompanying the November, 1981 25% across-the-board cut in loan guarantees contained the gratuitous and wholly erroneous suggestion that drilling vessels, so important to the shipbuilding base as well as to energy objectives, could be eliminated from the Title XI program because it amounts to a subsidy to the oil companies. As noted above, Title XI rates are not subsidized rates in any event and the drilling companies using Title XI are entirely independent of the oil companies. The major oil companies do not use Title XI because they can borrow the funds cheaper themselves. At the same time, Title XI makes the vital difference between building drilling vessels in the U. S. and doing so abroad. Construction of drilling vessels keeps shipyard work forces in place and spreads out overhead which would otherwise have to be paid for by the Navy in its own shipbuilding program.

Many vessels privately financed with the help of the Title XI program are available to the Navy as auxiliaries and contribute substantially to the sealift capacity in both peacetime and in emergency situations. Thirty-four Title XI-built vessels are now in service under charter to the Military Sealift Command. We wish to emphasize that these privately-built vessels continue to be available for military use even if, as has happened, the original vessel owner goes bankrupt. As noted above, thus far the combination of preferred mortgages and the user-funded ship financing fund has covered such defaults. Nevertheless those vessels are available for national defense purposes with no expenditure of government funds.

If Title XI's contribution to the national defense shipbuilding base and naval auxiliary fleet, all without cost to the Government, were eliminated and the cost transferred to the Defense Department Budget, it would result in a substantial increase indeed.

Mechanisms for Authorization Control

You have asked for our suggestion as to a mechanism dealing with the issues presented by federal involvement in the credit market. We have previously suggested that each Federal direct loan or guarantee program be assessed individually, as to its budgetary and economic impact, and as to its effectiveness in achieving its legislative purpose, a view we read as consistent with that of the Administration witnesses before this Task Force. That notwithstanding, the Administration has, without any reference to the particular authorizing statute and, despite the refusal of the authorizing Committee to give the Administration authority to do so, imposed annual ceilings on the amount of Title XI guarantees which may be issued. Having first set those annual limits, it has lumped Title XI with all other federal guarantee programs and subjected them to across-the-board cuts. Yet no analysis of the individual merit of the Title XI program in terms of the criteria suggested by the Administration to this Task Force has been undertaken.

Shipbuilding is a highly capital-intensive, long lead time industry. Financial planning requires a modicum of certainty. The traditional Title XI authorization process whereby the authorizing committees have adjusted the statutory ceiling at approximately 3-year intervals has worked well. I want to emphasize that setting an authorization level for a program such as Title XI has no budgetary or economic effect whatever. The government has no liability, not even contingently, until guarantees or commitments to guarantee are issued under the authorization. Within the authorization level, the market for capital equipment have set reasonable annual limitations. Administrative limitations such as have been imposed unilaterally by the Office of Management and Budget have been disruptive and counterproductive. Since the program has had only positive economic and budgetary consequences and since, as shown, cut-backs in the program will inevitably have immediate adverse economic and budgetary consequences, we would ask this Task Force to recommend that Title XI continue to be authorized at 3-year intervals by the authorizing committee and be subjected to no arbitrary yearly limitations.

Senator GORTON. Mr. Keeney, is not one of the central problems that we have with the administration, all of these guarantees are for building ships, the users of which could purchase identical ships outside of the United States for at or sometimes less than the cost that it takes to build them here?

Mr. KEENEY. It is certainly true.

Senator GORTON. That does not go to your national defense argument but it goes to an argument of national efficiency.

Mr. KEENEY. No, sir, it does not, because of the trickle through effect of the employment, the actual cost to the Government of losing that employment as well as the national defense feature. But the reason that ships are available at these costs in foreign countries, comparable or half the cost or less, is the fact that the subsidies, which Patricia Barrett has mentioned so well that those countries offer, and which we have not asked for.

Senator GORTON. Would you suggest that we solve part of the Barrett suggestions by prohibiting the use of foreign aircraft in the United States?

Mr. KEENEY. No, sir.

Senator GORTON. What is the difference?

NO CARGO PREFERENCE IS PROBLEM

Mr. KEENEY. I do not suggest that you prohibit the use of foreign ships in the United States. Many ships are built in foreign countries and used in trade in the United States to this day. One of our problems in the shipbuilding industry and in the maritime industry today is the fact that we have no cargo preference as compared to other countries. At the present time, we have existing de facto embargo by the very fact of the administration barring Russian ships from this country and they will not buy grain if they cannot ship it in their ships. That is cargo preference.

Senator **Gorton**. What is going to happen in the course of the next year if your industry has $4 million in applications and if commitments are limited to $600 million?

Mr. **Keeney**. There is $1.9 billion of that that is subject to delay or loss and deferral to foreign countries which would be lost to our economy and lost to production in our shipyards.

Senator **Gorton**. And the balance?

Mr. **Keeney**. The balance is questionable as to its activity of the total of $4 billion. Some of that $4 billion is long-term pending, and I personally feel it should be stricken from the pending applications.

Senator **Gorton**. So the $4 billion figure is somewhat higher than the realistic figure?

Mr. **Keeney**. Yes, sir; it certainly is.

Senator **Gorton**. What would you say would be a realistic figure?

Mr. **Keeney**. $2.5 billion.

Senator **Gorton**. That is still four times what the administration's proposal is for this year?

Mr. **Keeney**. Yes, sir.

As I have said in my oral presentation and also in my written statement, the marketplace itself has been a great control as to the use of title XI and there has never been default in title XI which cost the taxpayers because of the management of the program and the stringent controls that the Maritime Administration places on the award of these guarantees; capital formation requires the user to come forward with 25 to 40 percent of the money, so it is not one of these programs where you go to the window and have no risk. You have to put up the first 25 or 40 percent of the money and in addition justify very thoroughly the need for the program in the industry.

MARITIME ADMINISTRATION DOING FANTASTIC JOB

The Maritime Administration does a fantastic job and I think that speaks to the fact that there is only 0.8-percent loss and it has been paid back out of user funds and there is a growth surplus.

I think that the marketplace itself controls the use of that.

Now, for the first time, OMB has come in and first of all, the first part of last year they unilaterally cut it to $950 billion and in lumping all——

Senator **Gorton**. Million.

Mr. **Keeney**. Million, excuse me; $950 million and that is the first time any limitation has been on it other than the market limitation and then they lumped the title XI program with all other programs and cut 25 percent across the board.

The news release, the justification was that it was a subsidy for the oil companies in building oil rigs and as you probably know better than I, sir, oil companies do not build oil rigs; it is the independents that build oil rigs and they need this financing to be able to do it, to support the energy program.

We got lumped in and painted with a big black brush.

Senator **Gorton**. Ms. Barrett, as I understand it, Eximbank finances roughly 7 percent cf our exports. What are the new characteristics of those exports as compared to the other 93 percent? How is that other 93 percent financed and why the necessary inspection?

Ms. BARRETT. Eximbank finances almost uniquely capital equipment, the kinds of things that are usually extremely expensive and require a number of years before they can pay for themselves. The buyers usually require fixed rate financing and a long term.

Senator GORTON. What percentage of that kind of export?

Ms. BARRETT. The only figures that I have off the top of my head are that Eximbank finances the industries which comprise 25 percent of our manufacturing base and nearly 100 percent of our capital goods base.

ALTERNATIVE METHOD

Senator GORTON. Obviously, this kind of loan or guarantee is a method of promoting exports. Is there an alternative method that is workable at all? Is there an alternative method that would be as good as Eximbank?

Ms. BARRETT. I think the private banks would step up to the plate if we could get international agreement that our foreign competitors would not use Government subsidized financing.

Senator GORTON. In the absence of such agreements?

Ms. BARRETT. In the absence of such agreements, yes, there are ways to finance capital equipment.

I used to be a banker, and there are ways to finance it but if the French Government is offering 9 percent, 10-year loan at fixed rates, a U.S. commercial bank cannot step in there with a floating rate loan at 2 percent over what is called the London interbank rate. It is not a practical solution until such time as the international problem is solved. I think what we have to do is put our best economic intelligence on that problem and concentrate there.

Senator GORTON. All right, you anticipted my next question and answered it—Exim deals in both direct loans and guarantees?

Ms. BARRETT. Yes.

Senator GORTON. Would you describe the difference in the two? What type of industry and what type of purchaser normally uses each of those two Exim aids, and you might also tell me which you think is the more important.

Ms. BARRETT. Really, it is generally the same type of purchaser. It is always a purchaser of capital equipment. The direct loan program is a financing program. The Eximbank uses up to 65 percent of its own money out of 100-percent value of the equipment. It goes to the Federal Financing Bank and makes funds available to the supplier, but he makes them available to the borrower. The guarantees are necessary in a situation such as I mentioned earlier with an International Equipment Trust, plus in situations where private sector lenders might not be inclined to make a loan, let us say, for 20 years at a fixed rate. It may consider that the borrower is a good credit risk but the commercial bank might not be able to make the loan because of its duration and because of the fixed rate of interest.

DIRECT LOAN

Senator **Gorton**. Let us go back to the direct loan, then. That goes ordinarily to a borrower who the commercial bank would probably unwillingly loan, even if they were not facing their competition?

Ms. **Barrett**. That is not quite accurate; because the U.S. banking industry is so regulated that there is a rule and I do not know whether it is a national bank examiners or Federal reserve rule that says any commercial bank operating in the United States cannot use the existence of a Government guarantee as a basis on which to make a credit judgment.

With Eximbank financing, the Exim always makes sure that the commercial bank or an exported is in there for at least 15 percent of the loan and the Eximbank looks at the commercial bank's credit judgment on the borrower. So let us say Caterpillar Tractor is selling tractors to the Government of Indonesia, and let us say it is accompanied by a $50 million loan, the commercial bank has to look at that loan as if it were making the $50 million loan to the Government of Indonesia on its own hook, but in fact it only takes about 20 to 25 percent of that loan on its own hook and the Eximbank takes the rest of it. It is also true if a U.S. commercial bank wants to make COFACE loans in France, or ECGD loans in the United Kingdom, but no commercial bank is supposed to use that Government guarantee as a basis on which to make the loan.

Senator **Gorton**. One final question for you. One of the arguments that you have heard here today which has permeated all of the testimony before this task force, is that programs of this nature are taking capital out of the availability for general lenders. That dries up interest rates. It narrows the basis of interest for others and it drives up interest rates which are outside of these preferential areas.

Do I take it to be your view that even if we had substantially lower interest rates, the problems you describe in connection with Exim would not be cured because presumably so with these foreign subsidized sales, and I would ask the same question of Mr. Keeney, if interest rates drop 4 or 5 percent, you would still need these title XI guarantees?

TITLE XI GUARANTEES NEEDED EVEN WITH DROP IN INTEREST RATES

Mr. **Keeney**. Yes, sir, we would. The fact is that the long-term financing is what is primarily advantageous to the title XI financing. We can go get the financing through the guarantee, which is the 25-year life of the ship. A ship being of that cost, of the high cost factor that it is, it is hard to go to a bank and get them to finance anything; certainly they would not finance anything for that long a period of time and therefore you do not have that amortization schedule and the cost is prohibitive to do it on a shorter cycle.

Without title XI financing, I can tell, you that the shipbuilding industry in the United States will drop within a short period of months to probably a level of 50 percent of its last June level. That is a great deal of unemployment of 100,000 people and if it continues at the level that OMB has projected and continues to cut and let it die out in the next fiscal year, which probably would be very difficult to ever resurrect, it is my humble opinion that the shipbuilding industry will be destroyed in the next 18 months.

Ms. **Barrett**. On that question, Mr. Chairman, perhaps I can use Japan as an example today.

If interest rates were to go down significantly, down to the level of the internationally agreed upon rates, we would not have as much of a problem. We would still have a problem.

Today, Japan's long-term government borrowing rate is below the internationally agreed upon rate. Their long-term borrowing rate is roughly 7 percent, whereas the international rates are along the lines of a 9-percent rate. It can make Japanese yen loans to Indonesia through the commercial banking system, but in Japan, as in the United States, really, you still have the problem that borrowers in developing countries almost always demand a fixed rate of interest because they have a debt service budget that they have to stick to and they want to know exactly what the cost of the interest is going to be over the whole life of the loan.

The U.S. banking system, and very few banking systems around the world, except the Swiss, enjoy making fixed-rate loans. If you have ever tried to get a long-term fixed-rate loan out of a bank, you know what I am talking about. So to some extent, to mobilize the capital you would still need the guarantee.

Mr. **Keeney**. Mr. Chairman, getting a little afield from what I came to testify about, but I will tell you two little stories, if you will give me a moment.

Senator **Gorton**. I will do so.

EXIMBANK FINANCING MADE SALE OF TOW BOATS POSSIBLE

Mr. **Keeney**. I happened to sell six tow boats to Indonesia and it was because of Eximbank financing. There would have been no way I could have sold those ships and they were built in the lovely State of Louisiana, and shipped over there because of Eximbank financing.

Senator **Gorton**. Tell me how it is you were able to compete in Indonesia.

Mr. **Keeney**. It was not a price competition. They needed the long-term financing which our country gave to their country. It was not a competitive situation on pricing but the financing made it very desirable for them and they accepted the difference in cost.

As a matter of fact, I shipped the vessels aboard other ships to Singapore and they accepted delivery in Singapore with their own crew and took them back to Indonesia and they could have bought those ships in Singapore half price what I sold them for.

No. 2, I was in Egypt, or Cairo, a couple of years ago negotiating in the Suez Canal for six towing boats. I thought I was doing fine; I was going to close the deal for $14 million or $15 million worth of tow boats and all of a sudden, the Japanese came in, I told them I could work with them and help them get some Exim financing and pull some strings in Washington, and so along came the Japanese and said, we will give you 50 million dollars worth of financing as long as you spend it in Japan. The head of the Suez there said, what do you think of that?

I said, I am going to take the next flight home.

Senator **Gorton**. Thank you very much.

[Whereupon, at 4:14 p.m., the hearing was adjourned.]

OVERVIEW OF FEDERAL CREDIT

TUESDAY, JUNE 22, 1982

U.S. SENATE,
TEMPORARY TASK FORCE ON FEDERAL CREDIT,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:35 a.m., in room 6202, Dirksen Senate Office Building, Hon. Rudy Boschwitz presiding.

Present: Senators Boschwitz, Gorton, and Metzenbaum.

Staff present: Stephen Bell, staff director; David Nummy, special assistant to the staff director; Lizabeth Tankersley, minority staff director; and Ann Hadley, analyst for credit budget.

OPENING STATEMENT OF SENATOR BOSCHWITZ

Senator **BOSCHWITZ**. I am pleased to start today's hearing on legislative proposals to incorporate Federal credit activities into the budget process.

Since I first became involved in the efforts of the Budget Committee to investigate the credit activities conducted by our Federal Government, I have seen much progress in our understanding of this area and in our treatment of these transactions in the budget process.

FEDERAL CREDIT ACTIVITIES GROWING AT FAST PACE

At the time that Senator Muskie was the chairman, I asked him if he wouldn't have a subcommittee on this particular subject, and we did. The subcommittee met briefly, and I hope it will continue at a faster pace because the fastest growing part of the Government expenditures is in Federal credit activities, off-budget activities, of which there really is not a good record.

Targets for Federal direct and guaranteed loans have been included in the budget resolutions for the last 2 years. The conference on the first budget resolution, in which I participated, last week agreed to include language making these targets binding during the time the resolution is in effect in the same way that our spending levels are binding. The next logical step in our progress on credit is to incorporate such provisions in the Budget Act.

I am pleased to participate in the examination of these new areas, and I am particularly pleased to welcome Senator Percy as our first witness. He has been in the forefront of this area for a number of years, and it is appropriate that he lead our agenda. I am very familiar with his business background, so that he under-stands the meaning of credit and how it impacts on the budget process.

We welcome you, Senator Percy, and look forward to receiving your testimony.

STATEMENT OF HON. CHARLES H. PERCY, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator **Percy**. Mr. Chairman, I very much appreciate the opportunity to testify before the Budget Committee again. It was almost 2 years ago that I spoke with your predecessor task force to discuss the growing use of Federal credit programs.

I greatly appreciate your own interest in credit programs and the impact I think we all recognize that they have on the budget.

I would ask unanimous consent that the testimony that I have prepared for today be put in the record at the close of my remarks.[1]

Senator **Boschwitz**. Without objection.

Senator **Percy**. As you know, I have an appointment at 10 o'clock at the Sheraton Park Hotel with Mr. Begin, and therefore I will have to leave in just a few minutes.

FINANCE LENDING PROGRAMS BY SPENDING

What I would like to do is just summarize key points of my testimony. The first point is simply that Federal lending programs must be financed by Federal spending. Instead of paying for them with taxes, the Congress authorizes borrowing. The effect is the same on the economy. The pressure is on the private sector, sapping it of the resources for modernization and expansion.

Senator Boschwitz, both of us have had business backgrounds and we recognize that the Federal Government is in competition with the private sector for credit. The Federal Government gets the first call. Then the prime credit come in. That is why the small businesses, consumers and farmers, are just being squeezed out. They simply are just too far down the line for the limited amount of credit that is available.

HIGH INTEREST RATES TRACEABLE TO DEFICIT SPENDING

The second point I would like to make, is that high interest rates are traceable to deficit spending and excessive Federal borrowing. I have been a member of the business council for 25 years. I missed the last meeting at Hot Springs, Va., but I was startled to see the economic forecast made by the chairman of that committee, Charlie Brown, head of A. T. & T. He said that the economic forecast for the private sector is dependent—is dependent—on what the Congress does with the budget. They are so credit oriented now, the business and the private sector, to what interest rates are, as to what can be done to expand and grow in business. Whether they build plants or not, whether people buy homes or don't, or build homes, whether they buy automobiles, depends upon interest rates.

The private sector is saying it is up to us, and that decision rests right here with this Budget Committee. I want to commend this committee on having done an outstanding job in bringing down what would have been an otherwise totally unacceptable, horrendous budget deficit and for giving us a chance to aim toward that balanced budget.

---

[1] See p. 325.

It is going to take a lot of discipline and a lot of hard work.

The Director of the Congressional Budget Office, Alice Rivlin, stated in testimony before our Governmental Affairs Committee that passage of the legislation I have introduced would help bring about a decline in interest rates. So every single day that passes by that we do not have this legislation enacted, we are deterring the downward pressure that we want to bring on interest rates.

LENDING CONTROL LEGISLATION

In addition to the effect on interest rates, lending control legislation should address other points that affect operations of Government.

The impact of lending on the economy and projected Federal borrowing needs are two important items that Congress should be required to review. Hearings should be held by Congress at least annually to see if credit adjustments should be made. Interest subsidies should be evaluated.

In my testimony, I detail the hodgepodge of interest rates that are charged by the Federal Government now, sometimes it seems without rhyme or reason, other than that is what the Government used to charge, and it has no relationship to what the Government is now paying for money.

Eligibility should be reviewed with more carefully designed guidelines, and certainly Federal loan debts should be collected more efficiently. Debt collection legislation I have introduced, now passed by the House, will help collect some of the $46 billion in delinquencies on our books, and I would urge, Mr. Chairman, that you work with me to see that the leadership schedules the earliest possible time for this debt collection legislation.

Again, every day that goes by, we are missing a chance to collect tens of millions of dollars that delinquent borrowers owe; $46 billion is delinquent right now, much of it because of the sloppy procedures and lack of legislative mandate that would enable us to collect those debts.

REVIEW IMPOUNDMENT AUTHORITY

Finally, we need to make a careful review of impoundment authority and consider how a law might be structured to cover possibilities of lending impoundment.

Most of these concerns are taken care of in the legislation that I have introduced, cosponsored by Senator Domenici and Senator Gorton on this committee and 17 other Senators. S. 265 accomplishes better control over loan programs in two ways. First, it stipulates that loans and guarantees must be included within appropriations bills. Points of order could be raised against lending programs that are not subjected to the appropriations process.

Second, it requires that the budget resolution each year set forth appropriate levels of direct loans and guarantees by budget functions.

I think there is wide support for this approach. There are over 200 cosponsors are now on a similar House bill. It has the support of prominent economists like Alan Greenspan, Herbert Stein, and Charls Walker and the administration support S. 265. I hope this task force and the Budget Committee will support it, too. If I can say so, Mr. Chairman, because you are one of the few former businessmen in the Senate, I hope this legislation will have your own personal support and encouragement. I think that is exactly what is needed to move it ahead.

I commend you and Senator Gorton on the work of the task force and the work you are putting in to bring some order and reason out of this turmoil that we now seem to face. This is a part of it. This will put under control the budgetary process, something that is now off at loose ends, and yet has a marked impact on interest rates and on credit standing of the U.S. Government and the credit potentials for the private sector.

Thank you.

Senator BOSCHWITZ. Thank you very much, Senator Percy. I am certainly in agreement with you, and I will review the legislation that you have introduced. Apparently I am not a cosponsor.

Senator PERCY. I am disappointed to say that you are not.

Senator BOSCHWITZ. I will have to review it again. We certainly have a common purpose here, and a common feeling and understanding, I think, of the problem as well.

I know that you have an appointment.

Senator PERCY. I hope you will be with us at 11 o'clock.

Senator BOSCHWITZ. I will be.

This hearing will be adjourned until Senator Gorton comes, which will be about 10:15.

[Recess.]

PREPARED STATEMENT OF HON. CHARLES H. PERCY, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Mr. Chairman, it is once again a pleasure to appear before the Budget Committee's credit task force. I say "again" because it was July 1, 1980 -- almost two years ago -- that I spoke with your predecessor task force to discuss the growing use of Federal credit programs.

That task force -- and Senator Boschwitz was a strong supporter of that effort as I know he is of this one -- drew up a commendable record of the impact of credit programs on the economy. The credit task force's study was a landmark set of hearings for us in the Senate, because it was the first time that the Senate's attention was focused on this emerging aspect of Federal fiscal policy.

In my talks on Federal lending around Illinois, it is clear that the taxpayers are aware of this problem and that they view it as an important part of the Federal government's ability to cope with runaway spending. Taxpayers believe strongly that the Federal budget is the root cause of today's high interest rates. That association of high interest rates with the deficit is very strong on Main Street as well as on Wall Street. Economists tell us over and over again that if the deficit is brought down significantly, we will see less Federal borrowing and therefore less pressure on interest rates. In fact, that is the very reason the Senate -- and especially the members of the Budget Committee -- have been working so diligently this spring to curb the growth of spending. We want to reduce those pressures on credit markets and bring about a steady drop in interest rates.

One of the clearest statements on the relationship between high interest rates and borrowing was made last year by economists at Continental Illinois National Bank in Chicago. Continental's economists pointed out that "a great deal of market concern centers on the impact of Treasury borrowing needs in the new year and over the next several years to finance projections of sharply higher budget deficits. The fear is that these huge financing requirements will lead to renewed pressure on interest rates and, in effect, serve to 'crowd out' private borrowers. While most attention has focused on Federal borrowing to finance budget deficits, the expanded use of off-budget financing and Federally-sponsored and guaranteed loans also has had a major influence in the marketplace in recent years."

Irwin Kellner, economist for Manufacturers Hanover Trust in New York, was even more blunt. He has said that "the reported deficit is but the tip of the Federal financing iceberg..." and that "the economy is reeling because the credit markets have slammed into this iceberg." Kellner even believes that substantial progress against the deficit will leave the financial markets skeptical unless the invisible off-budget borrowing is curbed, too.

Mr. Chairman, these statements should cause great concern in Congress. The financial markets that determine the market price of money -- in other words, interest rates -- are well informed about Federal lending programs. The simple but painful truth is that Congress -- which created these programs in the first place -- knows very little about them. We cannot continue to pretend that Congressional ignorance of lending programs is shared throughout the economy. The private sector watches these programs very carefully. Moreover, it acts on Federal lending patterns as much as it does on other Federal financial developments.

In the two years since I last testified on behalf of this legislation, Federal borrowing from the public has continued to soar. In 1980, the Federal government borrowed $71 billion from the public. This year, borrowing needs are estimated to run at about $115 billion. Add on top of that the borrowing for guaranteed loans and you add another $44 billion this year, up from $32 billion just two years ago. But we are still not finished, Mr. Chairman, for there are the so-called government-sponsored enterprises which will borrow to the tune of $47 billion this year, double the 1980 borrowing of $22 billion.

That adds up to $206 billion in total Federal and Federally-assisted borrowing this year: twice this year's projected budget deficit for spending programs. If $100 billion deficits alarm the financial markets, imagine the response to $200 billion worth of financings. That is a financial iceberg, to use Dr. Kellner's phrase.

Mr. Chairman, one of the most recent statements by the Office of Management and Budget on Federal borrowing needs was made by OMB economist Lawrence Kudlow on June 3 before the House Banking Committee.[1] Although Mr. Kudlow was testifying on specific housing legislation, a number of his comments are relevant to your hearings today. I commend his remarks to this task force and think you will find particularly interesting the date he includes with his remarks which detail the growth in borrowing by the Federal

[1] See p.544

government and Federally-sponsored enterprises.

The one startling disclosure in Mr. Kudlow's remarks is that the Federal participation in credit markets -- the level at which Federal deficits and lending programs together will sop up private credit -- will hit an historic high of 56% in 1982. To put this figure into perspective, even following the severe recession of 1975, the Federal participation rate hit only 40%. I know there has been discussion about this crowding out. Let me bring to the task force's attention a copy of a St. Louis Globe-Democrat article entitled "Federal Borrowing Hike May Dry Up Credit Wells" that reports on this unprecedented level of borrowing.[1]

These statistics are of more than an academic interest to us of course. Ballooning Federal lending is leading to higher interest costs, as the Congressional Research Service pointed out in a report this spring. CRS states, "the reallocation of credit resulting from Federal credit programs imposes substantial credit access costs and higher interest costs on unassisted potential borrowers. Furthermore, higher interest costs on U.S. Government securities occur since Federal credit programs raise the total demand for loanable funds and thus interest rates."

Dr. Alice Rivlin of the Congressional Budget Office made a similar point in a letter to me last fall, which I would like to include in my remarks here today.[2] Dr. Rivlin stated that "if the Congress were to begin explicitly controlling the levels of new Federal credit, under procedures such as those in your bill, and began reducing total government credit demand, there is every indication that the financial markets would respond positively

[1] See p.557
[2] See p.558

and that interest rates would begin to decline."

Mr. Chairman, I ask that you include Dr. Rivlin's entire letter in your hearing record.

The level of interest rates, then, is my chief concern today and is the primary reason that Congress should act swiftly on this legislation. Your task force hearings are an important part of that process and I hope that the Governmental Affairs Committee -- which shares jurisdiction over this legislation -- will take a close look at it, too, this year.

With almost any program that grows quickly, there will be problems. Certainly the size of federal lending is one of those, but there are others. I believe passage of lending control legislation should incorporate provisions dealing with these concerns.

Foremost, I would say that Congress must begin to educate itself on Federal lending, Federal borrowing and the impact on the economy. Our banking committees have for many years had quarterly hearings on monetary policy. These sessions provide the committees with an opportunity for an exchange of ideas with the Federal Reserve and also provide a means for Congress to register its views on the conduct of monetary policy. Similar hearings should be held -- at least annually -- on lending programs and borrowing, investigating the impact future lending levels may have on private borrowing needs. Then if it seems that adjustments should be made in Federal programs, we would have an opportunity to do so.

Secondly, Congress needs to more carefully assess the interest subsidies that are involved in each of these lending programs. At my request, the Library of Congress reviewed Federal lending programs and found that only a few loan guarantee programs have statutory fixed interest rates. In fact, only 17 out of 153 loan guarantee programs have specific interest rates.

In the case of those programs where there is a fixed interest rate, it is sometimes so low -- by today's standards -- that it amounts, in reality, to an interest-free loan. For example, the Library of Congress found that community facilities loans carry an interest rate of 5%, with the Federal subsidy rising with the cost of government borrowing. It is not the only one. There are others just like it. Imagine subsidizing down to 5% from the current high rates of 14-15%. Congress may want to continue many of these subsidies. My point here is that we do not even know if we want to because we do not have a clear, organized way to review the programs subsidies.

Mr. Chairman, your task force will also be interested in this report by the Library of Congress and I ask that you incorporate it in your hearing record.[1]

A third important area that legislation should address is in the area of loan program eligibility. Who are we giving Federal assistance to and do they need it now in the same amounts as when the program was first passed? An excellent case of how Federal lending is handled occurred several years ago when the Economic Development Administration gave a steel company a loan guarantee to upgrade its rail mill. We all know the steel industry needs to modernize its facilities, but this particular loan guarantee caused a stir within the steel community because other companies had completed similar investments without Federal guarantees. Several companies were already meeting market demand

[1] See p.561

and it was argued that this EDA-financed mill built in excess capacity. Donald Trautlein, Chairman of Bethlehem Steel, wrote me about this and his company's subsequent advertisements that called for limiting Federal loans and guarantees. In the ad, Bethlehem states that "one way government makes our job harder is by interfering in the allocation of economic resources through Federal loans and guarantees...and at a time when investment capital is all too scarce." Here is another place for Congress to more closely police Federal policies to make sure that decisions affecting basic industries are made on an industry-wide basis and not incrementally as this one was.

The Federal Government is the world's largest credit institution. It is now owed $239 billion. The stability of any lending institution depends on careful credit extension, as well as effective debt collection -- unfortunately, Uncle Sam has done a poor job in both of these tasks.

On the debt collection side, the Government has failed miserably. Total delinquencies on Uncle Sam's books are now estimated to be $46 billion -- more than half of which is more than six months past due. This amounts to a staggering $500 for each of the 90 million taxpayers in this country. While about $20 billion is for delinquent taxes, most of the rest is delinquent loans. The agencies with the highest delinquencies are Agriculture with $4 billion, Education with $3 billion, and Small Business with $2.6 billion.

The reasons behind these losses are three-fold: the Government has often taken unnecessarily high risks in lending, it has placed primary emphasis on getting the money out the door with little effort given to collection, and Uncle Sam's hands have been tied in its attempts to use effective collection tools. Legislation I am sponsoring, S. 1249 -- the Debt Collection Act -- will provide the agencies with several collection tools, such as credit bureau reporting, which will finally put some teeth into federal debt collection. The bill has passed the House, and I expect Senate action very soon. The need for this bill only highlights the need to have a more comprehensive review of Federal lending practices.

Another area I would like to mention is impoundment authority. As you know, the Budget Reform Act of 1974 is silent on loans and loan guarantees and there is no control over the executive's ability to impound lending programs. Experts I have spoken with on impoundment of loan programs are divided over whether the Administration could actually take such action. We do know, however, that Congress does not have the tools -- deferral and rescission -- that are available to us in cases of spending impoundment. We need to undertake a careful review of this and consider how a law might be structured to cover possibilities of lending impoundment.

I fully appreciate the differences that exist between the many types of loan and loan guarantee programs. Most of the programs we have on the books are for domestic purposes, but the housing loan programs have played an increasingly important role in housing markets in recent years. We do not want to undermine those programs, but I hope the housing finance industry will work with us on developing legislation that will provide for an informed Congress on lending programs. It is not in the interest of the housing finance industry to see lending impoundment develop as a tool of Federal finance. Establishment of a Congressional credit budget process would give the housing finance an excellent opportunity to work with Congress to build a strong housing finance system that was fully backed by the Congress.

The Export Import Bank also offers a special case of loan programs. It is one of the few credit programs that is matched -- in fact exceeded -- by similar programs abroad. Japan, France, West Germany and Great Britain -- all have much more generous export financing that puts our exporters at a competitive disadvantage in marketing our products and services. Our government has sought for many years to negotiate an international agreement for the multilateral reduction of export credits. This effort has met with little success. That would be the preferred way to reduce this spiral of export financing competition, but it has not resulted in significant reductions. We will not reduce these credits by unilaterally reducing our own Export-Import Bank financing capability. Export financing credits must be dealt with in the larger international framework.

Mr. Chairman, I believe nearly all the concerns I have enumerated can be addressed in comprehensive lending reform legislation. My own legislation -- S. 265 -- accomplishes these major goals and has garnered the support of 20 Senators from both parties. A full list of the bill's cosponsors is attached to my remarks.[1] The bill amends the Budget Reform Act to establish procedures for setting targets and ceilings for loans and loan guarantees within the Congressional budget process. I would like to explain

[1] See p.573

the key aspects of how my bill would accomplish the goal of establishing a systematic mechanism for overseeing credit programs. The bill would:

- require that the budget resolution each year set forth the appropriate level of direct loans and loan guarantees. The budget is also required to itemize estimates of loan guarantees and direct loans by budget functions.
- require credit plans to be submitted to the Budget Committee by each authorizing committee. Presently, committees must submit their spending plans to the Budget Committee by March 15; the bill would extend this to loans and loan guarantees.
- require the Banking Committees to submit to the Budget Committees by March 15 each year their estimates and recommendations for the appropriate level of overall guarantees and loans for the next fiscal year. The Banking Committees would, in effect, evaluate the credit needs of private and public borrowers.
- stipulate that bills or resolutions authorizing new loans or guarantees must be reported from their respective committees by May 15. Bills reported after that date would face a point of order on the floor, as do all spending bills under the budget process.
- require the Congressional Budget Office (CBO) to report annually to the Budget Committees on credit programs of the Federal government.

- permit a point of order to be raised, after the second budget resolution is passed, against loans or guarantees that exceed the totals in the budget.
- stipulate that loans and guarantees must be included within appropriations bills. Points of order could be raised against loans or guarantees that do not subject themselves to the Appropriations Committees.

In closing, Mr. Chairman, let me point out that there is considerable support for this legislative approach. In the House, Representatives Mineta and Bethune have worked diligently on this issue for many years and have made a tremendous effort there, with well over 200 cosponsors. The administration has testified in support of the bill and prominent private economists such as Alan Greenspan, Henry Kaufman and Charls Walker support it and believe it will help lower interest rates. I hope this task force will support it, too, and appreciate this opportunity to appear before you today.

Senator GORTON [presiding]. The committee will come to order.

OPENING STATEMENT OF SENATOR GORTON

I would like to thank Senator Boschwitz for starting our hearing this morning so that I could fulfill a previous commitment.

When we started our hearings of the Task Force on Federal Credit, I noted that the Budget Committee is required by the Budget Act to study and report to Congress methods to improve the congressional budget process. In complying with that requirement, our task force was asked to examine Federal credit activities and to make recommendations based on our findings.

Previous hearings have revealed the large and growing nature of this area of government, now approaching $150 billion a year. It has also become apparent that the budget process does not adequately deal with this activity. Only 15 percent of the direct loan activity of the Federal Government is reflected as net outlays in the budget, and Federal loan guarantees are not reflected at all. Recognizing these shortcomings, numerous witnesses have repeatedly emphasized the need for incorporating Federal credit as a permanent part of the budget process.

Progress has occurred in this area. The Budget Committee has included targets for Federal credit in the budget resolutions for the last 2 years and the Conference on the First Budget Resolution agreed last week to include temporary enforcement language in the current resolution.

It is appropriate to turn now to a permanent legislative approach to a formal credit budget. I am pleased to have Members of Congress with us who have knowledge of this area and have taken the initiative to introduce legislation on this topic. S. 265, introduced by Senator Percy, and H.R. 2372, introduced by Congressmen Mineta and Bethune, would amend the Budget Act to place Federal credit under a similar process now used for spending. Senator Levin has introduced S. 2613, which places Federal loan guarantees under the impoundment control provisions of the Budget Act. Senator Proxmire will discuss legislation he has introduced which would address the use of the Federal Financing Bank and its impact on the budgetary treatment of Federal credit.

I appreciate the time these witnesses have taken to be here today.

Senator Percy has already spoken in an earlier part of the meeting chaired by Senator Boschwitz. Congressman Bethune has a Republican conference meeting. His remarks will be included in the record.[1]

We have with us live and in person Senator Carl Levin, who has a great interest in this area. We will be delighted to hear from you.

STATEMENT OF HON. CARL LEVIN, A U.S. SENATOR FROM THE STATE OF MICHIGAN

Senator Levin. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you and before the Budget Committee's task force on credit, and in this brief statement I want to focus on a specific issue, loan guarantee programs and administration actions which unilaterally reduce those program levels after the Congress has set them.

I want to share with the task force some history about specific loan guarantee programs, but first I would like to place this issue in context briefly and in my mind that context is nothing less than historic.

UNILATERAL DECISION MADE BY EXECUTIVE BRANCH

Each year since 1921, the administration in power has submitted its budget plan to Congress, but since the founding of the Nation it has been up to Congress to adopt the budget after identifying the perceived needs of society and balancing those needs with available economic resources. Congress works to achieve this balance through committee hearings, at which the administration defends its proposal, and a multitude of interests seek to change it. In short, it is in Congress, and not in the executive branch, that conflicts over budget priorities are ultimately resolved.

The executive branch is free to reject these decisions through a veto or seek to veto those decisions through the mechanisms established in the Impoundment Control Act of 1974. But the executive is not free, should not be free, and under our system of government cannot be free, to ignore a congressional mandate or modify it unilaterally to conform to its own notion of what is appropriate economic or social policy.

---

[1] See p. 574.

Yet that is precisely what has been happening in the area of loan guarantees.

Congress acted to establish guaranteed program levels for fiscal year 1982. The executive branch then made a unilateral decision to reduce those levels. It did not veto our decisions. It did not formally notify the Congress of reductions in program levels. It just simply decided to ignore the will of the Congress, the will expressed in law, which ought to be as binding on the President who executes the laws as it is on the public, which is expected to obey the laws.

The executive branch's unilateral reduction of established levels for loan guarantee programs is, in my mind, a critical constitutional issue. At issue is the nature and scope of congressional and executive powers in this constitutional government of ours. To ignore the procedural issues raised because one may want to cut the Federal budget, because one thinks loan guarantees are excessive, is to establish or at least sanction a course of conduct that will haunt us on other issues in other years. It is also a course of conduct which tolerates improper means to accomplish arguably justifiable ends.

One may disagree with the actions that Congress takes, but one ought not to be free to ignore them.

POLLUTION CONTROL FINANCING GUARANTEE PROGRAM

Just a few specifics, Mr. Chairman. One program I have a particular interest in is the Small Business Administration pollution control financing guarantee program. This program guarantees the financing required by small businesses to install federally-mandated pollution control equipment. The theory behind the program is a sound one. Small businesses simply cannot obtain the reasonable financing for federally-required, non-income producing pollution control equipment. Since the Federal Government requires the equipment, and since the people at large benefit from its installation, it seems reasonable for us to help finance it through this loan guarantee program.

In March of 1981, the administration request was only $95 million for this program. In May of that year, Senator Hayakawa and I held hearings on this program in the Small Business Committee, which indicated there was more legitimate demand than could be met with the $95 million. As a result, the committee increased the level to $250 million in the 1981 Reconciliation Act. The Appropriations Committee adopted a limit of $250 million as well. Despite this action by Congress which the President signed into law, the administration announced on November 5, 1981, that they were reducing this program to $50 million.

This announcement also reduced levels for other loan guarantee programs established by Congress and enacted into law, and I have a copy of this press release announcing these unilateral executive reductions of our actions, dated November 5, 1981, which I would like to submit for the record.[1]

Senator GORTON. Without objection.

Senator LEVIN. The Senate was unable to accept the decision—without prejudicing the question of whether there was any authority for the executive branch to make such a decision—and passed an amendment to the State-Justice Appropriations bill which set a floor for pollution guarantees at $175 million. But again, despite the reiteration of congressional policy, the administration in February of this year set a new ceiling of $150 million for this program, $25 million below the floor set by the Senate, and $100 million below the congressionally established figure which was signed into law.

---

[1] See p. 581.

SEVEN PROGRAMS SLASHED

It wasn't just this program which was unilaterally reduced. Seven SBA guaranteed program levels were slashed by the executive, a total of $1 billion in congressionally authorized loan guarantees was unilaterally stripped away by the executive. Thirteen other agencies and programs were also affected by independent executive decisions, including the Government National Mortgage Association, GNMA, Rural Electrification, and telephone revolving fund, and the Export-Import Bank.

The scope of the administration's action in the face of congressional decisions required a firmer institutional response. In our second concurrent resolution, I offered and amendment which ultimately became section 136 of Public Law 97-92, and that section states that:

> Notwithstanding any other provision of this joint resolution, subject only to the absence of qualified applicants, and within the limits of funds and authority available, the head of each department and agency for which authority to enter into commitments to guarantee or ensure is provided for in this joint resolution shall enter into commitments to guarantee or assure the full amounts provided for in this joint resolution, or other applicable law.

This requirement expires at the end of this fiscal year, and thereafter if we do not act we can expect the executive branch to act again—act in ways which undercut our constitutional authority and undermine the decisions that we have made.

We must act, Mr. Chairman, and act decisively, to protect the integrity of the budget process and the spirit of the Constitution.

Some action in this area has already been taken. In addition to the amendment that I offered to the continuing resolution, five authorizing committees adopted anti-impoundment provisions designed to protect loan guarantee programs under their jurisdiction when they consider the fiscal year 1983 budget request developed by the administration.

But that is a piecemeal approach to a problem that ought to be resolved clearly.

S. 2613 WOULD PROTECT LOAN GUARANTEES

Accordingly, Mr. Chairman, I have introduced S. 2613 which would protect congressional decisions about loan guarantees from unilateral executive reduction. In essence, S. 2613 requires the administration to treat loan guarantee authority in the same manner as budget authority for the purposes of the Impoundment Control Act of 1974. If the administration wants to modify congressional actions in the area of loan guarantees, they should be required to meet all the requirements now associated with recissions and deferrals of budget authority.

Finally, Mr. Chairman, this bill notifies the executive branch that Congress intends to exercise the authority to decide and to alter where necessary levels for guarantee programs, and the levels we set are to be utilized by agencies and departments in full, except in the absence of qualified applicants.

It is Congress responsibility to establish program levels and unless we are vigilant those levels will be decided, not by legislation, but by executive fiat.

Not by law, but by press release. That is what has happened on loan guarantee programs, where unilateral executive action reduced the levels set by law on loan guarantee programs. To that extent, constitutional government in America will be diminished.

SAFEGUARD GUARANTEE AND INSURANCE PROGRAMS

I urge the task force, if it recommends legislative proposals altering the budgetary treatment of Federal credit activities, to include my language safeguarding guarantee and insurance programs. Moreover, this is not a partisan issue. It is an institutional issue of the highest order. Executive usurpation of the Congress[1] authority to establish budget priorities is wrong—regardless of who the President is or who the budget director is. It is just plain wrong and we must firmly put an end to it.

Senator GORTON. How does the bill, in your own mind, relate to other bills on the subject which would essentially have us treat both direct loans and loan guarantees in the same way that we do appropriations for the budget process? Are they consistent with one another, and do they support one another?

Senator LEVIN. Yes, and I think the direct loans should be included as a number of other bills provide, and they are consistent with that approach.

Senator GORTON. It seemed to me to be the case as I went through your statement here.

Howard?

Senator METZENBAUM. No questions.

Senator GORTON. Thank you for coming.

Senator Proxmire, we are delighted to have you.

Senator METZENBAUM. Off the record.

[Discussion off the record.]

STATEMENT OF HON. WILLIAM PROXMIRE, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator PROXMIRE. Mr. Chairman and Senator Metzenbaum, I want to congratulate both of you, and I want to congratulate this committee for holding these hearings. I think they are extraordinarily important, and I want to congratulate the press here. Down the hall, as I came along here, I noticed the television cameras were in profusion. I can't imagine they have a hearing as important as this one, because the most significant element in our economy today is high interest rates, high interest rates caused by Federal credit that has run amok.

The fact is, I am going to point out in my statement, that the Federal Government is dominating the credit markets now and there is one reason for this recession, and that is that high interest rates have knocked the automobile industry to its knees and knocked the homebuilding industry flat on its back, and paralyzed much of small business. If we are going to do something about it, I think we have a chance to do something about it with the kinds of proposals you have from Senator Percy and others who appear before the committee this morning.

CREDIT PROGRAMS CONTINUE TO GROW

The Senate Budget Committee has been in the forefront of our efforts to bring Federal credit programs under better control. As a result of hearings held by this and other Committees, many Members of Congress are now beginning to realize that Federal loans and loan guarantees are not cost free and that their unchecked growth can dry up the availability of credit in the private economy to meet productive needs.

During the last 5 years, Federal lending has grown twice as fast as Federal spending. The net amount of new credit made available under all Federal credit programs increased from $37 billion in 1977 to a projected $115 billion in 1982. This represents an annual growth rate of 26 percent, whereas Federal spending grew only 13 percent a year during the same period. About 95 percent of the growth in Federal credit programs occurred outside the unified budget.

The rapid growth of Federal credit programs has diverted an increasingly larger share of our national savings away from productive investments in the private economy, as I have been saying. In 1977, Federal programs enjoyed 12 percent of the credit available in the economy. By 1981, it was 27 percent. When the deficits were added, it was 35 percent in 1981, and could exceed 50 percent in 1982.

I understand the Congressional Budget Office thinks it will exceed 50 percent in 1982. So it is little wonder that the interest rates are so high. Whatever the Federal Government wants to get, it gets, whether it has to pay 10 percent, or 15 percent, or 20 percent. This is not true in the private sector.

People back away from buying a home if they have mortgage rates of 16 or 17 percent. They back away from buying a car when they find the financing cost is too big. Most of the rapid growth in Federal credit programs occurred without any systematic determination of priorities by Congress. We made loan guarantees to bail out New York City and Chrysler. Meanwhile, thousands of small businessmen went bankrupt because of high interest rates.

We are making billions of dollars in loan guarantees available to synthetic fuel plants, too risky for the private market to finance, while the housing industry is practically decimated.

We have guaranteed millions of dollars to Soviet bloc countries, when the prospects for repayment are dubious. And we have made subsidized credit available to increase our exports of long distance jet aircraft when U.S. companies have had a virtual monopoly of the market.

BRING CREDIT PROGRAMS UNDER CONTROL

We must bring Federal credit programs under better control if we are to spur our lagging productivity and bring down the astronomically high interest rates that have devastated our economy.

Efforts to control Federal credit programs have proceeded along two channels. The first is to establish binding ceilings on the aggregate amount of Federal credit activity through the Congressional budget process as reflected in legislation introduced by Senator Percy and Congressman Minetta. The second is to close some of the gaps in the unified budget that permit Federal credit activity to be recorded outside the unified budget. The most notable gap is the exclusion of the Federal Financing Bank.

In my opinion, both approaches are needed to bring Federal credit programs under better control by the Congress. I would, however, like to confine the remainder of my remarks to the second approach and to my legislation for including the activities of the Federal Financing Bank in the unified budget.

I would, however, like to include in the record of these hearings at the end of my statement a copy of my remarks on the floor of the Senate when I introduced this legislation, S. 2162.[1] I will now proceed to summarize these remarks.

Senator GORTON. Without objection.

Senator PROXMIRE. The Federal Financing Bank is a relatively obscure agency of the Treasury that operates wholly outside the budget and the regular appropriations process. It has no tellers, no windows, no pillars, and is not even listed in the phone book. It has only seven full-time employees, and yet it holds $107 billion in outstanding loans and lends over $20 billion a year. In just 8 years it has become the third largest bank in the United States, and it will soon be the largest.

The other day we had the Chairman of the Board of Citibank, Walter Riston, appearing before the Banking Committee, and he said he had more people working for Citibank than were the population of the town in which he grew up, which is Appleton, Wis., which has about 90,000 people. This little old Federal Financing Bank is crowding them in competition and has only seven employees.

The bank was established by the Congress in 1973 in order to provide for a more efficient method of financing, Federal credit programs. Prior to 1973 a number of Federal agencies were selling their own securities directly in the Government securities market, but often at a cost substantially above the cost of Treasury financing.

The Financing Bank is able to provide a lower cost financing vehicle for these agencies with funds borrowed from the Treasury. The effect of the financing bank legislation is to substitute Treasury borrowing for agency borrowing at a lower net cost to the Government. The legislation also provided that the receipts and disbursements of the bank shall be excluded from the unified budget.

---

[1] See p. 592.

UNIFIED BUDGET SHOULD INCLUDE FEDERAL FINANCING BANK

The Federal Financing Bank certainly plays an important role in our system of Government finance. I supported the establishment of the bank in 1973, and I continue to support its existence. However, I strongly believe that the time has now come to include the operations of the bank in the unified budget.

The same conclusion was reached by the General Accounting Office and the House Budget Committee. Similarly, a recent report by the Congressional Budget Office has documented the distortions arising from the bank's budget exemption.

A budget serves two main purposes: First, it should provide a complete and accurate recording of the total operations of the United States Government. Second, it should provide a rational method of allocating scarce dollars among competing uses. Excluding the Federal Financing Bank from the budget violates both of these purposes.

Excluding the Federal Financing Bank from the budget misleads the public about the true size and scope of the Federal Government's activities and its budget deficit. Had the operations of the bank been included in the budget in fiscal year 1981, total outlays and the Federal deficit would have been $21 billion higher. Instead of a $58 billion deficit, the real deficit was $79 billion.

At a time when we are trying to reverse the relentless expansion of the Federal Government, we do not serve our purposes well by attempting to conceal $21 billion in additional deficit spending. This money must be borrowed by the Treasury along with the money needed to finance the recorded budget deficit.

There is no difference in either type of borrowing. Each has the same inflationary effect on financial markets and the economy. We are simply fooling ourselves and impairing our own credibility when we perpetuate these budgetary gimmicks.

POSSIBILITY OF MISALLOCATED RESOURCES

Keeping the Federal Financing Bank off-budget also undermines our ability to allocate dollars wisely. The availability of off-budget financing through the bank gives certain favored credit programs an unfair advantage in the competition for Federal funds.

Outlays by the bank increased at a 29 percent rate over the last 5 years, a growth rate that is more than twice the rate of increase in on-budget programs. As a result, there is a strong possibility that we have misallocated resources. This means that the American people are not getting the maximum benefit from the expenditure of Federal dollars. It also means that we in the Congress are not doing the job for which we were elected.

Previous attempts to put the Federal Financing Bank in the budget have met with technical objections from the Treasury. One argument has been that it would not be appropriate to assign the budget authority and outlays to the Treasury when the underlying transactions are initiated by other Federal agencies. Another argument is that placing the bank in the budget would cause Federal agencies to finance their programs directly in the Government securities markets again, thereby resurrecting all of the problems that gave rise to the establishment of the bank in 1973.

S. 2162 WILL OVERCOME TECHNICAL OBJECTIONS

My proposed legislation, S. 2162, is designed to overcome these technical objections while still placing the activities of the bank in the budget.

First of all, it repeals Section 11(c) of the Federal Financing Bank Act which provides that none of the receipts and disbursements of the bank shall be included in the budget of the United States.

Second, it requires the director of the Office of Management and Budget to issue regulations assigning the budget authority and outlays arising from the banks' operations to the appropriate Federal agency, notwithstanding any contrary law or regulation.

This provision would override various special statutory provisions such as the favorable treatment given to certificates of beneficial ownership issued by the Farmers Home Administration.

Third, the legislation would prohibit Federal agencies from financing their program in the Government securities market unless the securities were first offered to the bank. The Secretary of the Treasury would be permitted to waive bank financing in cases where the security was not an appropriate investment for the bank.

Fourth, my proposed legislation would not become effective until fiscal year 1984 because, otherwise, I think we are out of the barn already on 1983.

STEP TOWARD "TRUTH IN BUDGETING"

Putting the operations of the Federal Financing Bank in the budget will provide the Congress and the public with a more accurate picture of the size and scope of the Federal Government's activities. It will also insure that Federal credit programs financed through the bank compete, dollar for dollar, with all other Federal programs. I believe this legislation is an essential first step toward truth in budgeting, and I am hopeful it can be enacted this year.

Finally, over the next few months the Congress will have to vote for a deficit probably exceeding $100 billion. These are very unpopular votes. They will be difficult to explain to the voters back home, many of whom feel the Federal Government is simply out of control.

Therefore, I believe the Congress needs to demonstrate that it is beginning to put our fiscal house in order. Putting the Federal Financing Bank in the budget and passing the Federal credit budget legislation are essential elements in our efforts to reassure the American people that the Congress will indeed face up to its fiscal responsibilities.

Senator GORTON. Bill, thank you for that brilliant and, I may say, most persuasive statement. Just to get all of these in context, however, could you comment on this: Let's assume that this proposal passes along with Percy, Mineta, and Bethune proposals. Will we have solved all the problems we have with Federal credit?

Senator PROXMIRE. By no means. This is not a panacea. This gives us a basis for exerting the control. Exerting the control is going to be extraordinarily difficult. Without this kind of legislation and the Percy legislation, it will be very hard.

Senator **Gorton**. Such legislation contributes procedural reforms.

Senator **Proxmire**. Yes. The pressures will still be there to spend more money, and make more loans, and hold down taxes, and those are the pressures we will have to resist if we are going to make progress in getting the borrowing down.

CBO PROPOSES THREE BUDGETS

Senator **Gorton**. CBO has suggested a different approach. Rather than mixed lending and spending in one budget as we do now, under CBO's proposal, the Government would have three budgets, one for direct spending, one for direct loans, and one for loan guarantees.

Each of them would be matched against its respective offsets, and the deficit would thus accurately reflect the increase in Federal borrowing necessary to meet the cash shortfall in spending and direct loans.

Have you heard of this proposal?

Senator **Proxmire**. I have not heard of it before, at least not in that detail. Just offhand, I would think there is considerable merit in that, but I would hope there would be some way we could consolidate this and put it together.

I can remember some years ago when the uniform budget was proposed and first advanced, I guess during the Johnson Administration, and that seemed to be somewhat helpful. I would think that having three separate budgets would be confusing, and there would be a tendency for us to concentrate primarily on the traditional budget and to ignore the credit budget, feeling that, well, maybe that doesn't have quite the same effect. It would be some time, I think, before Congress realized it does have the same effects on the credit markets, the same effects on interest rates, and a considerable effect on our economy.

Senator **Metzenbaum**. Bill, this is a subject some of us have had concern about, going back to the days when Senator Muskie was chairman of the Budget Committee. We have had difficulty moving something forward in Congress. I hope under Senator Gorton that we will be able to make some headway, because I think it is absolutely irresponsible, and almost fraudulent on the American people, for them not to know of these off-budget items.

OBLIGATIONS OWED TO GOVERNMENT IMPOSSIBLE TO FIND

There is another part of this whole project that bothers me, and I think you may have some insight on it that I would like you to share with us if you do. That is the fact that nowhere in this Government is it possible to find out what obligations are owed to the Government, whether it is the SBA, the Government student loans, or farmers' loans, Farmers Home Loan Bank, or any one of a host of others.

There really is no way of punching a computer button and saying, there is so much owed. But beyond the question of how much is owed, there is no way of knowing actually what is in default.

No two agencies have the same means of determining when a loan is or is not in default, and my question is, do you have any thoughts, and you have certainly been well versed in this whole problem of Federal credit, and my question is, what, if any, thoughts do you have as to how we might be able to determine or to advise the agencies when a loan is in default or when they are to say it is in default.

It doesn't serve the agencies' purposes well for them to have a figure indicating that they have 30 percent of their loans in default or 40 percent, or it is better if it is only 2 percent.

As a consequence, I don't think any of them, and I checked one time, had any rule of thumb to say, "Well, this agency says when you are in default 60 days, and therefore the entire loan has been called and you are in default." They just don't do that at all. Here we have the GSA administrator who hasn't paid the interest on his loan, and certainly under any normal procedure the entire loan would become due and payable under those circumstances if you were at a bank, and we don't run the Government that way.

Do you have any thoughts on the overall subject?

WAY NEEDED TO TELL WHEN LOANS ARE DEFAULT

Senator PROXMIRE. Well, I think this is something that we certainly ought to have.

As you say, because we have different definitions of default, because we perhaps don't keep our statistics as accurately as we could, we just don't know how much is owed.

I would think that what we need here, however, is a record. We should secure from the General Accounting Office and the Treasury and the Federal Reserve and other people who are expert in the area their opinions as to whether or not we can have a uniform definition, applicable to all agencies, as to what is a default, and the uniform system of reporting on that so we have that information available.

I would think that that would be achieveable. There may be reasons for not trying to put it all together, but I think this is a very constructive suggestion that you are making, Senator Metzenbaum. I don't see any reason why we can't get that information.

Frankly, I am a little surprised that we don't already have it, and I think this is very revealing that we don't have it. We should have it.

Senator METZENBAUM. Thank you.

Senator GORTON. Bill, thank you very much for helping us today. You are most enlightening.

Senator PROXMIRE. Thank you very much.

Senator GORTON. Congressman Mineta?

As previously stated, the co-sponsor of H.R. 2372, Congressman Bethune, cannot be here before us today, but his testimony has been put in the record in full.

Senator METZENBAUM. If I leave a few minutes to eleven, I am due somewhere else. We appreciate your coming over.

Senator GORTON. For some reason or other, I think he rates the prime minister of Israel ahead of you. Is that what it is for?

Senator METZENBAUM. Not ahead of him, but I don't think Norm has any war going on.

Senator GORTON. Congressman Mineta?

STATEMENT OF HON. NORMAN Y. MINETA, A U.S. CONGRESSMAN FROM THE STATE OF CALIFORNIA

Mr. MINETA. Maybe I should join you with the prime minister.

I would like to take this opportunity to thank you, Senator Gorton and members of the task force for holding these hearings on credit budget legislation. The House Budget Committee task force on enforcement, credit and multiyear budgeting, which I chair, has held several hearings on the need for a credit budget and the impact of Federal credit activity on the economy.

However, unlike the House Budget Committee, the Senate Budget Committee does have the authority to report legislation. We can only make recommendations to the House Rules Committee on Budget Act reforms. I am very pleased to participate in today's hearing, and I am hopeful that the hearing will take the Senate Budget Committee one step closer to developing and possibly reporting out credit budget legislation.

Since the enactment of the Congressional Budget and Impoundment Control Act of 1974, the budget process has been faced with a series of challenges. These challenges have been especially tough in the past 2 years. Faced with unprecedented budget deficits, Congress has been forced to make extremely difficult budget choices. Self-discipline is always uncomfortable. Ordering priorities is burdensome. In my view, the budget process is necessary. This country cannot afford to return to the practice of uncontrolled Federal spending. In my opinion, the budget process is still evolving as a fiscal policy tool, and after more than 7 years of experience with the budget process, the time is right for examining it and considering ways in which it might be strengthened and improved.

MAKE CREDIT BUDGET PART OF BUDGET PROCESS

One of the most important steps Congress can take to improve the Budget Act would be to make the credit budget a required part of the budget process. The Budget Act fails to address credit activity, the fastest-growing form of Federal financial assistance, and an important method by which the Federal Government influences the allocation of economic resources.

In the last decade, and particularly during the last 6 years, Federal credit programs, direct loans, and loan guarantees have been growing faster than direct spending programs. Since 1976, Federal credit has grown at a rate of 27 percent a year, more than doubling every 3 years.

By contrast, in the same period budget outlays rose by about 12 percent a year. Consequently, credit programs account for an increasing proportion of all Federal financial assistance. When the Budget Act was enacted, tighter controls were placed on Federal spending. The loan guarantees were specifically excluded from coverage by the Act, and the change in severity of controls over direct spending relative to loan guarantees may have prompted an increased use of the guarantee mechanism.

FEDERAL CREDIT PROGRAMS HAVE IMPACT ON MARKETS

Undoubtedly, the lower budget visibility of credit programs contributed substantially to the spurt in Federal credit activity. We know that the impact of Federal credit programs on capital markets and the economy can be tremendous. They can shift capital from one sector to another, and they can raise interest rates for those not eligible for Federal credit assistance.

Federal credit activity impacts markets in several ways: direct loans and loan-guaranteed programs, borrowing by government-sponsored enterprises, bonds for local housing developments and so forth and financing the budget deficit. Such large Federal demands on the capital market raise the possibility that a large amount of private credit activity may be crowded out.

It is essential that the Congress thoroughly examine Federal credit activities, and the credit budget is a vehicle Congress can use to make decisions about how much the Federal Government should influence the allocation of credit resources. The credit budget encourages us to consider the full impact of credit programs on the economy, on private credit markets, and on the beneficiaries of credit assistance as well as on the Federal budget.

GREATER SCRUTINY OF PROGRAMS NEEDED

Recognizing the need to subject Federal credit programs to a greater degree of scrutiny, I introduced in 1979 the Federal Credit Program Control Act. This bill would have extended the target- and ceiling-setting procedures of Title III of the Budget Act to gross direct lending and loan guarantees creating in effect a credit budget in the congressional budget process. The purposes of such a credit budget are to exercise greater control over the growth of Federal credit activities and to insure that the level of resources for these activities is justified, that the allocation of resources among the various programs is consistent with national priorities and that more careful consideration is given to the impact of total Federal activity on the economy as a whole.

Similar bills were introduced in 1980 by Representative Ed Bethune and Senator Charles Percy. Last year, Mr. Bethune and I joined forces in a bipartisan effort to introduce the Federal Lending Oversight and Control Act, H.R. 2372. By amending the Budget Act, this bill, if enacted, would subject Federal lending programs to the same annual budgetary scrutiny that is currently practiced for direct spending programs.

While plans for direct and guaranteed loans for individual Federal credit programs are reviewed each year, until the fiscal year 1981 budget there was no systematic mechanism in the Congress or the executive branch for reviewing the total volume of Federal credit activity.

In its fiscal year 1981 budget, the Carter administration developed a Federal credit budget consisting of estimates of new direct loan obligations and new loan guarantee commitments and requests for appropriated limitations on annual loan program levels. Congress responded by including the targets for aggregate amounts of new on- and off-budget direct loan obligations and new primary and secondary loan guarantee commitments in the budget resolution for fiscal year 1981. Annual limitations were enacted for commitments for new direct loans and new loan guarantees. These limitations were included in the appropriations language for most budget accounts containing direct or guaranteed loan programs.

CREDIT ENFORCEMENT PROVISIONS ADOPTED

Last week, House and Senate budget conferees moved closer towards control of Federal credit activity by adopting credit enforcement provisions in the budget resolution for fiscal year 1983. The provisions agreed to by the conferees extend the target- and ceiling-setting procedures of the Budget Act to direct loans and loan guarantees.

As I have already stated, I agree that the credit budget should be fully incorporated into the budget process, but the enforcement language contained in the conference report responds only to the control of Federal credit activity—ceilings will now be placed on Federal credit programs. The enforcement provisions do not, however, solve the more urgent problems of congressional examination and review of Federal credit activities. Given the current tight credit markets and the growing concern with the increase in Federal participation in those credit markets, Congress must carefully monitor the use of Federal credit assistance in a way that considers Federal priorities as well as the needs of the national credit markets.

Congress must determine whether the social benefits for a given credit program are worth the costs of any economic inefficiency that might be created by such a program. Congress must decide how much federal credit assistance should be extended, and equally important, at a time when the amount of credit available is limited, Congress must determine which sectors of the economy are most deserving and most in need of this assistance.

Congress did not exercise this review during the fiscal year 1983 budget cycle of the past few months. In short, Congress did not take the responsibility for developing a credit budget that assures that scarce credit resources are allocated to achieve maximum public good.

H.R. 2372 AND S. 265 RESPOND TO OVERSIGHT AND CONTROL

H.R. 2372, the Federal Lending Oversight and Control Act, and Senate companion bill S. 265, the Federal Lending Program Control Act, respond to oversight as well as control. These bills establish credit program controls through amendments to title III and IV of the Congressional Budget Act of 1974. The bills add to title III, which establishes the concurrent budget resolutions on budget authority and outlays, provisions to expand the target- and ceiling-setting process to gross direct lending and to loan guarantees. Title IV, which establishes procedural mechanisms to prevent future back door spending, is amended to require appropriations actions for direct loans and loan guarantees to become effective.

The bills apply controls to Federal credit programs similar to those placed on direct spending programs. Standing committees will be required to include in their March 15 reports to the Budget Committee their recommendations for credit program levels and their estimates of direct and guaranteed loan authority to be provided in their bills.

In addition, the Banking Committees in each house will be required to include recommendations of overall levels of credit assistance in their March 15 reports.

This essential review and reporting process was not practiced during the fiscal year 1983 budget cycle and as a result the credit figures appearing in the budget resolution for fiscal year 1983 do not reflect adequate consideration of credit programs by Congressional Committees.

LACK OF CONTROL FOR LOAN GUARANTEES

A remaining problem that would not be resolved by either H.R. 2372 or S. 265 is the lack of control for loan guarantees. The Reagan Administration has used the credit budget as a tool for implementing budgetary control by making large reductions in loan commitments and direct loan obligations. One of the main features of President Reagan's September 24, 1981 announcement of a budget deficit reduction package was a $21 billion decrease in new Federal loan guarantee commitments for fiscal year 1982. In fact, the loan guarantee reduction was the only part of the package which was actually implemented because the reductions were achievable primarily through executive action.

Under current law, it appears that the administration will implement reductions in loan guarantees without congressional approval. Although Congress had adopted program levels for many of the loan guarantees eventually reduced by the administration, there was nothing to prevent the administration from restricting commitments even if there were qualified borrowers.

Whenever the administration proposes a smaller credit program level than the limit approved by Congress, we can expect the administration to allow only the lower level to occur.

LOAN GUARANTEES SHOULD BE INCLUDED

In response to this situation, Senator Levin included mandatory language in the continuing resolution passed in December, 1981. The language established credit limitations at mandatory program levels except in programs lacking sufficient qualified borrowers, in effect preventing reductions in these programs. To correct this weakness in congressional control of loan guarantees, Congress should consider expanding the provisions of the Budget Act's impoundment control to include loan guarantees. Congress needs a process to determine for itself whether the benefits for a given program are worth the cost and to be able to make its own decisions regarding how much Federal credit assistance should be extended and which sectors of the economy are most in need of this assistance.

The Federal Lending Control Act has over 240 cosponsors in the House, and was the subject of hearings before the Task Force on Enforcement, Credit and Multiyear Budgeting on October 28 and 29, 1981. The witnesses which included Alice Rivlin, Director of the Congressional Budget Office; Richard McNamar, Deputy Secretary of the Treasury; Nancy Teeters, Governor of the Federal Reserve

Board; and Lawrence Kudlow, Assistant Director of the Office of Management and Budget, strongly support enactment of this legislation.

Given the growing concern with the increase in Federal activity and its impact on interest rates and credit markets, I hope that Congress will act quickly to adopt H.R. 2372 and S. 265 so that we can implement the necessary oversight provisions to complement the control provisions which were included in the Conference Report on the Fiscal Year 1983 First Budget Resolution.

Senator, I have a full statement which I would like to have included as part of the record.

Senator GORTON. It will be included.

Mr. MINETA. Thank you.

Senator GORTON. Thank you Congressman Mineta.

PREPARED STATEMENT OF HON. NORMAN Y. MINETA, A U.S. CONGRESSMAN FROM THE STATE OF CALIFORNIA

I want to take this opportunity to thank Senator Gorton and the Members of this Task Force for holding these hearings on credit budget legislation. The House Budget Committee Task Force on Enforcement, Credit and Multiyear Budgeting, which I chair, has held several hearings on the need for a credit budget and the impact of federal credit activity on the economy. However, unlike the House Budget Committee, the Senate Budget Committee does have the authority to report legislation. We can only make recommendations to the House Rules Committee on Budget Act reforms. I am very pleased to participate in today's hearing, and I am hopeful that the hearing will take the Senate Budget Committee one step closer in developing and possibly reporting out credit budget legislation.

Since the enactment of the Congressional Budget and Impoundment Control Act of 1974, the budget process has been faced with a series of challenges. These challenges have been especially tough in the past two years. Faced with unprecedented budget deficits, Congress has been forced to make extremely difficult budget choices. Self-discipline is always uncomfortable. Ordering priorities is burdensome. And, saying "no" is unpopular. Consequently, the budget process has come under the attack of many Members of Congress and several interest groups. In my view, the budget process is necessary. This country cannot afford to return to the practice of uncontrolled federal spending.

Before the adoption of the Budget Act, Congress was ill-equipped to take an overall look at the economic environment. The only budget was the President's budget, and it served as a basis for all fiscal policy discussion and for some legislative action. Under the Budget Act, Congress has a set of procedures which provide order, guidance, and information in assessing the relative merits of federal spending with the overall needs of the economy. To this end, the budget process has basically proven to be a procedural and informational success. It is now, however, being tested as a fiscal policy tool, and there is some dissatisfaction that Congress is not exerting effective budgetary control.

In my opinion, the budget process is still evolving as a fiscal policy tool, and after more than seven years of experience with the budget process, the time is right for examining it and for considering ways in which it might be strengthened and improved.

One of the most important steps Congress can take to improve the Budget Act would be to make the credit budget a required part of the budget process. The Budget Act fails to address federal credit activity -- the fastest growing form of federal financial assistance and an important method by which the federal government influences the allocation of economic resources.

Growth in Federal Credit Activity

In the last decade, and particularly during the last six years, federal credit programs--direct loans and loan guarantees--have been growing faster than direct spending programs. Since 1976 federal credit has grown at a rate of 27 percent per year, more than doubling every three years. By contrast, during the same years budget outlays rose at a rate of about 12 percent annually.

Consequently, credit programs account for an increasing proportion of all federal financial assistance. By fiscal year 1980, one of every eight dollars of assistance provided by federal agencies was in the form of a direct loan or loan guarantee. The volume of loans and loan guarantees outstanding had climbed to $462 billion, a figure two-thirds as large as the federal debt in 1980. During fiscal year 1981, the gross volume of new loans and loan guarantees extended by the federal government is estimated to total $147 billion, a 23 percent increase over 1980. These figures are not adequately reflected in the budget of the federal government. Direct loan disbursements are offset by repayments. Consequently, the economic impact of new direct loans are understated when expressed as budget authority and outlays. Federal guarantees are reflected in the federal budget only when defaults occur, forcing the federal government to make guarantee payments. The practical result is that the economic and budgetary consequences of federal credit programs are often ignored by Congress when it formulates its annual budget plans.

When the Budget Act was enacted, tighter controls were placed on federal spending, but loan guarantees were specifically excluded from coverage by the Act. The change in severity of controls over direct spending relative to loan guarantees may have prompted an increased use of the guarantee mechanism. Undoubtedly, the lower budget visibility of credit programs contributed substantially to the spurt in federal credit activity.

Impact of Federal Credit Activity

We know that the impact of federal credit programs on capital markets and the economy can be enormous. They can shift capital from one sector to another, and they can raise interest rates for those not eligible for federal credit assistance.

The federal government impacts credit markets in several ways: direct loan and loan guarantee programs; borrowing by government-sponsored enterprises; bonds for local industrial and housing development subsidized through tax exemptions; and financing the budget deficit. Such large federal demands on the capital markets raise the possibility that a large amount of private credit activity may be "crowded out."

Among the varieties of ways the federal government intervenes in the credit markets, direct loans and loan guarantees, which account for 16 percent of all funds advanced in the economy, merit special attention. Many of the loans are heavily subsidized, and subsidized credit displaces credit that would have been extended for activities considered more profitable by market standards. By financing less productive activities, subsidized credit programs can reduce the efficiency of the nation's capital stock. Little analysis has been done to determine whether the positive social benefits of federal credit assistance are worth any losses in economic efficiency which occur as a result of the assistance provided. Although loans and loan guarantees may at times be the best method for providing federal assistance, Congress does not exercise the needed review and assessment of credit activity. The failure to account fully for credit programs in the budget gives them an inappropriate advantage over direct spending programs. Improved budgetary oversight of loan and loan guarantee programs could enable Congress to monitor their use and growth in a way that would consider federal priorities as well as the needs of national credit markets.

It is essential that Congress thoroughly examine federal credit activities, and the credit budget is a vehicle Congress can use to make decisions about how much the federal government should influence the allocation of credit resources. The credit budget encourages us to consider the full impact of credit programs on the economy, on private credit markets, and on the beneficiaries of credit assistance, as well as on the federal budget.

The Federal Lending Oversight and Control Act

Recognizing the need to subject federal credit programs to a greater degree of scrutiny, I introduced in 1979 the Federal Credit Program Control Act. This bill would have extended the target-and ceiling-setting procedures of Title III of the Budget Act to gross direct lending and loan guarantees, creating in effect a credit budget in the congressional budget process. The purposes of such a credit budget are to exercise greater control over the growth of federal credit activities, and to insure that the level of resources for these activities is justified, that the allocation of resources among the various programs is consistent with national priorities, and that more careful consideration is given to the impact of total federal credit activity on the economy as a whole.

Similar bills were introduced in 1980 by Representative Ed Bethune and Senator Charles Percy. Last year, Mr. Bethune and I joined forces in a bipartisan effort to introduce the Federal Lending Oversight and Control Act. By amending the Budget Act, this bill, if enacted, would subject federal lending programs to the same annual budgetary scrutiny that is currently practiced for direct spending programs.

While plans for direct and guaranteed loans for individual federal credit programs are reviewed each year, until the fiscal year 1981 budget, there was no systematic mechanism in the Congress or the executive branch for reviewing the total volume of federal credit activity. In its fiscal year 1981 budget, the Carter Administration developed a federal credit budget consisting of estimates of new direct loan obligations and new loan guarantee commitments, and requests for appropriated limitations on annual loan program levels. Congress responded by including targets for aggregate amounts of new on- and off-budget direct loan obligations and new primary and secondary loan guarantee commitments in the budget resolution for fiscal year 1981. Annual limitations were enacted for commitments for new direct loans and new loan guarantees. These limitations were included in the appropriations language for most budget accounts containing direct or guaranteed loan programs.

Last week, House and Senate Budget Conferees moved closer towards control of federal credit activity by adopting credit enforcement provisions in the Budget Resolution for fiscal year 1983. The provisions agreed to by the conferees extend the target- and ceiling-setting procedures of the Budget Act to direct loans and loan guarantees.

As I have already stated, I agree that the credit budget should be fully incorporated into the budget process, but the enforcement language contained in the Conference Report responds only to the control of federal credit activity--ceilings will now be placed on federal credit programs. The enforcement provisions do not, however, solve the more urgent problem of congressional examination and review of federal credit activities. Given the current tight credit markets and the growing concern with the increase in federal participation in those credit markets, Congress must carefully monitor the use of federal credit assistance in a way that considers federal priorities as well as the needs of the national credit markets.

Congress must determine whether the social benefits for a given credit program are worth the costs of any economic inefficiency that might be created by such a program. Congress must decide how much federal credit assistance should be extended, and equally important, at a time when the amount of credit available is limited, Congress must determine which sectors of the economy are most deserving and most in need of this assistance.

Congress did not exercise this review during the fiscal year 1983 budget cycle of the past few months. In short, Congress did not take the responsibility for developing a credit budget that assures that scarce credit resources are allocated to achieve maximum public good.

Plan of Credit Budget Proposals

H.R. 2372, the Federal Lending Oversight and Control Act, and Senate companion bill S. 265, the Federal Lending Program Control Act, respond to oversight as well as control. These bills establish credit program controls through amendments to Title III and IV of the Congressional Budget Act of 1974. The bills add to Title III, which establishes the concurrent budget resolutions on budget authority and outlays, provisions to expand the target- and ceiling-setting process to gross direct lending and to loan guarantees. Title IV, which establishes procedural mechanisms to prevent future "backdoor" spending, is amended to require appropriations actions for direct loans and loan guarantees to become effective.

The bills apply controls to federal credit programs similar to those placed on direct spending programs. Therefore, the first issue that must be decided is the point at which controls are to be placed. Two criteria guided the definition of control points in these bills.

First, controls are on a gross basis rather than the net of repayments basis used to report direct loans in the unified budget. Gross level controls are the most direct means of regulating program levels. Second, controls are applied at the point in the lending or guarantee process when the federal government commits itself and cannot cancel the loan or guarantee arrangement without the agreement of the other party or parties. Simply put, controls should be applied at the point where the government cannot change its mind.

Based on these criteria, the bills set the control point for direct lending at the obligations stage and for guaranteed lending at the commitment stage.

Direct Loans

For the purposes of these bills a direct loan is defined as a disbursement of funds (not in exchange for goods or services) that is contracted to be repaid--with or without interest--or any of the following transactions:

- direct federal participation in loans privately made or held;
- purchase of private loans through secondary market operations; or
- acquisition of federally-guaranteed private loans or collateral in satisfaction of default or other guarantee claims.

Direct federal loans are already included in the unified budget totals on a net of repayments basis. Net lending, the change recorded in the budget totals for a program for a fiscal year, equals the amount of new loans extended minus the amount of loan repayments on all--new and prior--loans during the fiscal year.

Net lending is an appropriate indicator of the changes in an agency's financial picture resulting from the operations of a direct loan program. It is not, however, a satisfactory indicator or point of control of program activity. Net lending on-budget understates the amount of new credit extended by the federal government by the amount of the deducted repayments and by the amount of off-budget lending. These deductions are not trivial. New lending by the federal government for fiscal year 1981 is estimated to be $56.7 billion. Deducting repayments ($20.7 billion) and loans by off-budget agencies ($32.1 billion) leaves net lending recorded in the budget at $3.9 billion. Direct federal lending in 1981 is thus understated in the budget by $52.8 billion. Policymakers should be aware of this $53 billion of federal lending. Even though net extensions of federal credit are estimated to total only $3.9 billion, the full amount of credit diverted by on-budget agencies from the borrowers to whom the marketplace would allocate credit to borrowers selected by the federal government is $56.7 billion.

Because the economic effects of direct federal loans to selected borrowers are assumed to differ from the economic effects of the loans that would have been extended in the marketplace, the Congress should consider targets and ceilings, controlling the gross amounts of credit diverted, not just the annual net additions to federal direct loans outstanding. Therefore, the bills require that targets and ceilings be set in the concurrent budget resolutions on the gross obligations for the principal amount of direct loans. The total is not reduced because of repayments, prepayments, sale of loan assets defaults, or loan forgiveness.

Guaranteed Loans

Guaranteed loans are included in the unified budget totals only to the extend defaults occur resulting in the use of budget authority. The amounts of defaults is very small compared to the volume of assistance provided through loan guarantees. Thus the targets and ceilings on budget authority and outlays in the concurrent budget resolutions have almost no effect on the ability of agencies to offer loan guarantees.

The bills introduce for the first time controls on total commitments by the federal government to guarantee loan principal in all loan guarantee programs. Two aspects of this point of control merit discussion: applying controls at the commitment stage and counting only guaranteed loan principal against the targets or ceilings.

The bills supply controls on loan guarantees at the stage when a federal agency enters into a guarantee agreement that becomes effective at such time as the lender meets stipulated preconditions. In a sense, the commitment stage of a loan guarantee arrangement is equivalent to the obligation stage of a direct loan arrangement. The government has entered into an agreement which can be expected, without further intervention, to mature into a financial responsibility to provide loan principal or guarantee a loan's repayment, as the case may be.

Applying controls at the commitment stage of loan guarantees is appropriate because at the point a commitment is granted, there is no reason for the borrower or the lender to search for alternative financing means. At that point the federal government has in a sense "siphoned" credit out of the market and allocated it to a borrower who, without the guarantee, would not have been allocated credit on those terms, or perhaps on any terms at all.

The second aspect of the bills' controls on loan guarantees that merits discussion is the fact that only the federal government's contingent liability is counted against the individual program limitations and the targets for ceilings in the budget resolution. Where the principal amount of a loan is only partially guaranteed, only the amount of the contingent liability is controlled. For example, a limitation of $500,000 for a program of 90 percent guarantees means that the agency could guarantee loans totaling $555,355; only $500,000 of the principal, however, would be guaranteed by the government. This provision will make it possible for programs of partial guarantees to leverage their limitation of guarantee commitments into a larger total volume of loans than a program of 100 percent guarantees. It is consistent with the treatment of partially guaranteed loans in the Administration's credit budget.

Reporting Requirements

Standing Committees will be required to include in their March 15th reports to the Budget Committee their recommendations for credit program levels and their estimates of the amounts of direct and guaranteed loan authority to be provided in their bills. In addition, the Banking Committees in each House will be required to include recommendations of overall levels of credit assistance in their March 15th reports. This essential review and reporting process was not practiced during the fiscal year 1983 budget cycle. As a result, the credit figures which appear in the Budget Resolution for fiscal year 1983 do not reflect adequate consideration of credit programs by Congressional Committees.

Remaining Problem of Impoundment Control

A remaining problem that would not be resolved by either H.R. 2372 or S.265 is the lack of impoundment control for loan guarantees. The Reagan Administration has used the credit budget as a tool for implementing budgetary control by making large reductions in loan commitments and direct loan obligations. One of the main features of President Reagan's September 24, 1981 announcement of a budget reduction package was a $21 billion decrease in new federal loan guarantee commitments for fiscal year 1982. In fact,the loan guarantee reduction was the only part of the package which was actually implemented because the reductions were achievable primarily through executive actions.

Under current law, it appears that the Administration can indeed implement reductions in loan guarantees without Congressional approval. Although Congress had adopted program levels for many of the loan guarantees eventually reduced by the Administration, there was nothing to prevent the Administration from restricting commitments even if there were qualified borrowers. Whenever the Administration proposes a smaller credit program than the limit approved by Congress, we can expect the Administration to allow only their lower level to occur.

In response to this situation, Senator Levin included mandatory language in the Continuing Resolution passed in December, 1981. The language established credit limitations as mandatory program levels except in programs lacking sufficient qualified borrowers, in effect, preventing administrative reductions in these programs.

To correct this weakness in Congressional control of loan guarantees, Congress should consider expanding the provisions of the Budget Act's impoundment controls to include loan guarantees. Dr. Alice Rivlin, Director of the Congressional Budget Office, in testimony before my Task Force on Enforcement, Credit and Multiyear Budgeting in October, 1981, recommended two options for solving the impoundment control inadequacy: 1) the definition of budget authority in the Budget Act could be revised to include loan guarantees; or 2) a new kind of authority--loan guarantee authority-- could be created instead and subjected to the Budget Act's impoundment control provisions. Senators Levin and Moynihan have recently introduced legislation which would subject loan guarantees to impoundment control.

Conclusion

Congress needs a process to determine for itself whether the benefits for a given credit program are worth the costs and to be able to make its own decisions regarding how much federal credit assistance should be extended and which sectors of the economy are most in need of this assistance.

H.R. 2372, The Federal Lending Oversight and Control Act, has more than 240 cosponsors in the House and was the subject of hearings before the Task Force on Enforcement, Credit, and Multiyear Budgeting on October 28 and 29, 1981. The witnesses, which included: Alice Rivlin, Director of the Congressional Budget Office; Richard McNamar, Deputy Secretary of the Treasury; Nancy Teeters, Governor of the Federal Reserve Board; and Lawrence Kudlow, Assistant Director of the Office of Management and Budget, strongly support enactment of this legislation.

Given the growing concern with the increase in federal activity and its impact on interest rates and the credit markets, I hope that Congress will act quickly to adopt H.R. 2372 and S. 265 so that we can implement the necessary oversight provisions to complement the control provisions which were included in the Conference Report on the Fiscal Year 1983 First Budget Resolution.

LEVERAGE PLACED ON HOUSE TO ACT

Senator **Gorton**. The point you made outlines the authorities between the Senate and House Budget Committees with respect to legislation. With that in mind, what are the prospects for your legislation in the House? Is there any possibility of moving it independently? Is there a greater possibility if some such legislation were actually adopted by the Senate?

Mr. **Mineta**. Hearings have been held before the Rules Committee of the House. If the Senate were to move on this legislation, it would be tremendous leverage on the House to act. We have through the good efforts of my colleague, Congressman Bethune, who I am sorry is not here, he is preoccupied with the budget resolution which will be on the House floor starting at noon today, managed to get 240 cosponsors of this bill.

Under any other circumstances, that would be more than a sufficient number of sponsors to move that kind of legislation through the House.

The fear on the House side has been that because there are so many people who are basically trying to do damage to the budget process itself, if we open up the Budget Act to any amendments, some Members will try to get into the act to try to tear the process apart. Therefore, there is a reluctance to move ahead with legislation to amend the Budget Act.

This, I think, has been the feeling of Congressman Dick Bolling, who chairs the House Rules Committee, and who was instrumental in putting together the Budget and Impoundment Control Act of 1974.

But it seems to me that if we were to move on just this amendment from the Senate side first, then this would have a tremendous leverage on the House to move.

Senator **Gorton**. We share that fear here on the Senate side as well, of course.

Mr. **Mineta**. You have only 100 aligators. We have 435.

Senator **Gorton**. True. On the specifics of it, both H.R. 2372 and S. 265 require future loan guarantees and direct loan programs to be subject to annual appropriations limitations, but there is no requirement for existing credit programs to be subject to the appropriations process.

Is the control of future credit programs by the appropriations process sufficient to bring the credit budget under control in your view?

Mr. **Mineta**. Well, it is like anything else. I think what we have to do is set the tone for the future, and I think that that is probably a more realistic political approach than trying to impact existing programs. Political reality is the only reason that we look more toward future programs than to existing programs.

IMPACT OF BILL ON ENTITLEMENT CREDIT PROGRAMS

Senator **Gorton**. How would your bill impact on entitlement credit programs?

Mr. **Mineta**. Well, of course, just by definition, if a qualified borrower steps up to the window, let's say through a disaster loan program, the borrower would be eligible for assistance. This is one of the problems with the numbers that were put into the Fiscal Year 1983 budget resolution conference report that we now have before both bodies of the Congress. In those areas where you have an entitlement program, credit limits have been set very low. However, because it is an entitlement program the ceilings set in the budget resolution can and will be exceeded. Whereas those programs that are nonentitlement and really controllable have ceilings set much, much higher than the administration requested and higher than the House and Senate Budget Committees recommendations.

Senator GORTON. So the answer is no procedural thing like this can control entitlement programs. We can simply include them in the budget and watch them as they go by.

Mr. MINETA. That is right.

INCLUDE DIRECT LOAN OBLIGATIONS

Senator GORTON. If Congress passes the bill like yours or that of Senator Percy, both guarantee commitments and direct loan obligations would be incorporated into the budget process. Senator Levin's bill which you indicated support for incorporates loan guarantee commitments in the impoundment control provisions of the Budget Act, but doesn't do the same thing with direct loan obligations.

Now, would you extend it to include direct loan obligations as well?

Mr. MINETA. I don't think there would be any problem extending impoundment control provisions to the direct loan programs.

Senator GORTON. I would assume the philosophy would be equally applicable, wouldn't it?

Mr. MINETA. I think so. I don't believe there would be any differences in their treatment.

Senator GORTON. Since you are about to deal with the budget itself, I will thank you very much for coming over here and for all the work you have done. I hope we can move forward.

Mr. MINETA. Not at all, Senator. You play an important role in getting this legislation passed, given that you do have legislative powers in the Senate Budget Committee.

Senator GORTON. We are going to try to do something with it.

Mr. MINETA. That is great news. It is encouraging.

Senator GORTON. Thanks, Norm.

Mr. Kudlow? We are delighted to have you with us. You may proceed.

STATEMENT OF LAWRENCE A. KUDLOW, ASSOCIATE DIRECTOR FOR ECONOMICS AND PLANNING, OFFICE OF MANAGEMENT AND BUDGET

Mr. KUDLOW. I am going to be very brief, and I will submit for the record my prepared statement.

Senator GORTON. We will include it in its entirety.

PREPARED STATEMENT OF LAWRENCE A. KUDLOW, ASSOCIATE DIRECTOR FOR ECONOMICS AND PLANNING, OFFICE OF MANAGEMENT AND BUDGET

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am pleased to appear before you today to discuss the principles involved in developing a credit budget, incorporating that budget into the Congressional budget process, and making that process a meaningful tool of public policy.

As you know, the Administration is firmly committed to the long-term goal of gradually reducing the level of Federal credit programs through the development of tougher standards for their administration and the introduction of additional programmatic and interest subsidy controls. Efforts to formalize the Congressional credit budget process, or to integrate the credit budget directly with the regular budget, would greatly enhance this effort. It is our hope that the Congress and the Administration can continue to work together to refine the credit budget and its use. The ongoing effort toward credit reduction and financial market relief should provoke a full examination of the proper accounting of these credit programs, with particular attention to the off-budget outlays.

The Administration enthusiastically supports the intent of legislation that would amend the Congressional Budget Act and integrate Federal credit activity into the Congressional budget process. Such legislation would represent a major step forward in the crucially important effort to restrain the adverse effects of Federal credit activity on the Nation's economy.

The need for a formal mechanism for exposition and examination of Federal credit is apparent. As we are all painfully aware, in recent years there has been an extraordinary disruption of financial market activity, marked by repeated record breaking interest rate levels. The break-down in the savings-investment-economic growth process and the steady cheapening in the value of money, in my judgment, largely can be attributed to the unchecked swelling of Federal taxes, spending, credit and debt. And this nearly unlimited fiscal expansion is best illustrated by the unprecedented increase in the many forms of Federal and federally-assisted borrowing over the past four years.

Burgeoning Federal credit activity -- direct Treasury borrowing, loan guarantees, and the activities of Government-sponsored enterprises -- has resulted in a steady increase in Federal absorption of capital raised in U.S. financial markets. Over the 1955-1969 period, the absorption rate averaged 17% while interest rates hovered at 4%. During the 1970's Federal credit absorption jumped to nearly 25% and interest rates nearly doubled. In the late 1970's and early 1980's, however, the absorption rate took another quantum jump -- to 35% -- while interest rates exploded into the double digit area.

Table 1

	Average Federal and Federally-Assisted Borrowing			
	Volume ($b)	Absorption Rate (%)	3-mo. T-Bill (%)	20-yr. T-Bond (%)
1955-1969	9.8	16.6	3.5	4.2
1970-1979	58.1	24.9	6.3	7.5
1980	124.4	35.5	11.4	11.4
1981	142.1	34.8	14.0	13.7

The economic impact of this alarming rise in Federal deficits and other forms of government borrowing is unmistakable. Even excluding loan guarantees, the rise in real government debt is clearly related to the fall in productivity, the slow-down in economic growth and the acceleration of inflation over the last major business cycle. From one business cycle peak to another the growth of real debt per capita has accelerated: from -1.8% during the lengthy expansion of the 1960's, to 0.8% during the intermediate length cycle of 1969-73, to 5.5% over the 1973-79 cycle.

But the growth in real per capita output has moved in the opposite direction, from 3.5% during the 1960's to 2.0% over the last cycle. Likewise, productivity growth has fallen from 3.1% to 0.8%, while the rate of increase in the GNP deflator has jumped from 2.6% to 7.5% over the period. Focusing on the 1973-79 interval, the Nation has produced real debt 175% faster than it has produced real income. Or put another way, the formation of real resources has been insufficient to cover the creation of real government debt, and thus has been inadequate to produce the real investment essential for the sort of steady economic growth and job creation necessary to employ a growing labor force.

Over the last 18 months the Administration has conducted the first comprehensive interagency review of all forms of Federal credit activity. By taking a broader -- and more accurate -- view of Federal credit, focusing on all of the government's lending and borrowing activity and going beyond the traditional view of deficits, we have come to recognize the full scope of the federal borrowing problem and we have discovered a more satisfactory explanation for the escalation of interest rates and the decline in economic performance which has characterized much of the past 10 or 12 years.

The review made it very apparent that any attempt to control the Federal borrowing problem must take into account the off-budget deficits and the government-sponsored enterprises. The need to address these aspects of Federal and federally-assisted credit has implications for the credit budget.

OFF-BUDGET CREDIT

The off-budget spending, borrowing and lending activity has by and large succeeded in escaping the full scrutiny of the public eye. Even the most sophisticated budget analysts tend mainly to focus on the more familiar on-budget outlays, receipts and deficits. Complex and intricate off-budget programmatic arrangements tend to go unnoticed or, if noticed, these arrangements are poorly understood. Legislation aimed at strengthening the credit budget should unmask the accounting facade of the off-budget world and reveal the true economic and financial significance of the off-budget activity.

As Table 2 indicates, the off-budget deficit increased three-fold between 1975 and 1980. Total budget outlays in 1981 have been understated by $21 billion.

With the exception of the Postal Service, the outlays of off-budget Federal entities occur principally with the implementation of various loan programs. These programs have the same characteristics and the same economic effects of direct loan programs that are scored as outlays in the budget. An off-budget outlay is an outlay by any other name. Similarly, an off-budget deficit absorbs valuable savings and capital just as an on-budget deficit. If it is true that the general public is largely unaware of this murky off-budget concept, it is also true that the financial community that ultimately funds these off-budget activities is distinctly and painfully aware of their true economic significance.

Table 2
The On- and Off-Budget Picture
(fiscal years, $ billions)

	Total Receipts	Outlays			Deficit			On-Budget Outlays % GNP	Total Outlays % GNP
		On-Budget	Off-Budget	Grand Total	On-Budget	Off-Budget	Grand Total		
1960	92.5	92.2	--	92.2	-0.3	--	-0.3	18.5	18.5
1961	94.4	97.8	--	97.8	3.4	--	3.4	19.2	19.2
1962	99.7	106.8	--	106.8	7.1	--	7.1	19.5	19.5
1963	106.6	111.3	--	111.3	4.7	--	4.7	19.2	19.2
1964	112.7	118.6	--	118.6	5.9	--	5.9	19.2	19.2
1965	116.8	118.4	--	118.4	1.6	--	1.6	17.9	17.9
1966	130.8	134.6	--	134.6	3.8	--	3.8	18.6	18.6
1967	149.5	158.2	--	158.2	8.7	--	8.7	20.4	20.4
1968	153.7	178.8	--	178.8	25.2	--	25.2	21.4	21.4
1969	187.8	184.5	--	184.5	3.2	--	3.2	20.3	20.3
1970	193.7	196.6	--	196.6	2.8	--	2.8	20.3	20.3
1971	188.4	211.4	--	211.4	23.0	--	23.0	20.5	20.5
1972	208.6	232.0	--	232.0	23.4	--	23.4	20.6	20.6
1973	232.2	247.1	0.1	247.1	14.8	0.1	14.9	19.7	19.7
1974	264.9	269.6	1.4	271.1	4.7	1.4	6.1	19.5	19.6
1975	281.0	326.1	8.1	334.2	45.1	8.0	53.1	22.0	22.6
1976	300.0	366.4	7.3	373.7	66.4	7.3	73.7	22.3	22.7
1977	357.8	402.7	1.8	411.4	44.9	8.7	53.6	21.6	22.1
1978	402.0	450.8	8.7	461.2	48.8	10.3	59.2	21.6	22.1
1979	465.9	493.6	10.4	506.1	27.7	12.4	40.2	20.9	21.5
1980	520.0	579.6	14.2	593.8	59.6	14.2	73.8	22.6	23.1
1981	599.3	657.2	21.0	678.2	57.9	21.0	78.9	22.9	23.7

With the aid of the Federal Financing Bank, a large portion of the government's loan guarantee commitments are converted into direct Federal loans outside the budget. The FFB purchases newly originated guaranteed loans with funds borrowed in money and credit markets under the aegis of the Treasury Department. The proceeds of this borrowing are then converted into direct loans.

The loans, however, are scored as an off-budget outlay for the FFB's own account. Although the outlays are not recorded in the budget, and although the FFB has no administrative control over the programs, this intricate procedure has nonetheless generated additional Federal spending and borrowing, exactly the same as any on-budget process. Although the FFB's borrowing requirement is not considered to be part of the official budget deficit, the resulting preemption of private capital is precisely the same as in the case of money borrowed to finance the official deficit.

GOVERNMENT-SPONSORED ENTERPRISES

There is another form of Federal intervention in credit markets I wish to discuss briefly: lending by the seven federally-sponsored credit enterprises, including FNMA, FHLMC and the Farm Credit System. The Congress and the Administration have no direct budgetary control over these entitites, and they are therefore not part of the credit budget.

The economic effects of sponsored enterprise lending are, however, quite similar to the effects of direct federal loans and guaranteed loans. A part of federally-assisted debt, their borrowings cause the same burden on financial markets, and generate the same upward interest rate pressures as do other forms of Federal borrowing. It is essential that these activities be considered an integral part of the overall credit policy picture.

Table 3

Government-Sponsored Enterprises: Net Lending
(in billions of dollars)

	4 year averages		Annual Data					
	1970-1973	1974-1977	1978	1979	1980	1981	1982	1983
Federal Home Loan Mortgage Corp. 1/	0.5	1.5	4.4	5.0	3.1	0.3	20.9	23.4
Federal National Mortage Association	3.3	2.8	7.0	8.0	6.5	4.1	12.6	12.5
Federal Home Loan Banks	1.2	1.5	12.1	9.9	6.5	20.5	4.6	5.0
Farm Credit Admin.	1.8	4.8	4.4	8.5	12.5	10.0	11.9	13.2
Student Loan Marketing Association	---	0.1	0.2	0.5	1.0	2.1	1.6	1.4
Less: Loans previously guaranteed by Federal Government and inter-agency lending	--	--	2.9	3.8	5.5	4.6	1.6	2.4
Total	--	--	25.2	28.1	24.1	32.4	50.1	53.1

According to the information presented by the government-sponsored enterprises in the February budget, their combined lending is expected to double between 1980 and 1982, from $24 billion to $50 billion, as shown in Table 3. In particular, FNMA and FHLMC are planning major expansion, as they develop large conventional mortgage pass-through security programs.

The implications of government-sponsored enterprise activity for the credit budget are important. An increase of $26 billion between 1980 and 1982 can more than offset the gains made by restraint in the credit budget itself.

The President believes that the economy is best served by strong private financial intermediaries; and any exception seriously erodes the Administration's general policy of avoiding special relief measures for particular industries or economic sectors. With this in mind, it is anticipated that a number of the special competitive advantages now accorded to government-sponsored enterprises will be gradually phased out, encouraging each organization to compete equally with other private, unsubsidized financial intermediaries. We look forward to working together with Congress on this important matter.

Mr. KUDLOW. Let me say at the outset that listening to Congressman Mineta and having testified before his task force last year as well as before this task force, I agree with the thrust of his remarks. The administration continues to support the Mineta-Bethune bill in principle. We have not looked at all the new wrinkles and details, but, as we did last year, we agree with that approach as well as the approach of similar bills that have surfaced.

In general, our position continues to be to press for tougher credit standards and to involve the credit budget in the overall budget process. My concern over the growth of Federal credit and off-budget programs is as strong now as it was last year, and my general view with respect to the economic impact of the extension of Federal borrowing is as strong as ever.

As we meet here this morning there is considerable unease in money and credit markets, much to the displeasure and frustration of Members of the Congress and members of the administration.

Interest rates are going back up.

We had all hoped that rates would descend late this spring and through the summer, and maybe they will, yet in the last 3 or 4 weeks we have seen long-term bond rates escalate by about 100 basis points, and short-term rates similarly.

We are in a turning point situation with respect to the economy. There are now growing signs that the recession is coming to an end and the recovery is beginning.

INTEREST RATE LEVELS INHIBIT STRONG RECOVERY

Senator GORTON. What kind of recovery can we expect with that kind of situation?

Mr. KUDLOW. We are all concerned that interest rate levels are going to inhibit the kind of strong, sustained recovery that everyone hopes for.

That leads me back to the issue of Federal borrowing and Federal credit programs of all sizes—recorded budget deficit, the so-called off-budget deficit, the loan guarantees and the Government-sponsored agencies. All are financed in the open market under the umbrella of Uncle Sam and contribute from time to time to interest rate pressures, distort the normal process of market risk-taking, and place borrowers at the head of the credit line because of the backing of the Federal Government. Undoubtedly from time to time this ingestion of Government bonds interferes with the conduct of monetary policy.

This is a serious issue, and there is no question that your task force and Mr. Mineta's are making progress in establishing new legislative principles. I can only applaud it, as I did last winter, and indicate that the administration will continue to support these approaches.

Let me add one final thought: The principle of the credit budget and efforts to move the credit budget into the overall congressional budget process is of course a crucial one. We want the public to see what is going on in this area.

EXAMINE EACH PROGRAM CAREFULLY

But we should consider as part of this new credit budget process the significance of examining the programs themselves, not only the budget process because this is where the real difficulty lies. My hope is, over time, as this credit budget process blossoms, matures, and becomes part of the overall budget picture, we will be able to do just that, because in the end, the expansion of credit occurs not in the aggregate but as specific programs to provide credit assistance. We should examine each program carefully to see whether it is fulfilling the function initially intended and if there is the kind of economic impact that was initially intended.

I hope to work with you and your committee in the process of going from the general to the specific in the period ahead.

Senator GORTON. I would like to ask you a few questions about general remarks before I go into the bill.

You have indicated this great concern over the prospect that interest rates may start to climb again rather than to decline.

Could you give us the benefit of some of your own expertise in that field? To what do you attribute the sign that interest rates may start to rise, and signs that there will be some recovery and the signs that the rate of inflation which we have had at such a delightfully low rate may be going back up to 6 or 7 percent? Have the money markets discounted already the lowering of the budget deficits to the extent that the resolutions before both House and Senate now incorporate, or do they simply not believe that we are not going to do even that well?

FEAR OF BUDGET NOT BEING CREDIBLE

Mr. KUDLOW. Speaking personally, I think the latter comment is perhaps more correct. I sense in my conversations with people in the financial community a great unease over prospects in fiscal year 1983, as well as the outyears. I know that the congressional budget process is making progress on these matters, and of course the administration has been deeply involved, but we still have to get past, not only the next 3 or 4 or 5 years, but also the next two or three quarters. I know a lot of people who are worried about the volume of Federal financing that will be required in the fourth fiscal quarter of 1982 and the first fiscal quarter of fiscal year 1983.

The budget numbers embodied in the first fiscal year 1983 budget resolution certainly are a major improvement over the current service level and baseline so widely popularized last winter.

But there is still a fear in the marketplace that the budget may not be credible. It is a kind of show me attitude. They want to see it in the law before we get a better environment.

Second, Senator, there is a fear that we may be not doing what we could have done on the credit side and that the financing of the loan guarantees and the off-budget guarantees are going to be a difficult burden to carry.

Federal credit demand is a more important problem for long-term interest rates than short term, but it is the long-term interest rates that have the greatest economic impact.

There is great fiscal unease and the movement of long-term rates in the last 3 or 4 weeks is an expression of that unease.

MARKET NOT PERSUADED

Senator GORTON. So apparently we have done too little, too late, and apparently we have not persuaded the market that we are now going to do even what we say.

Mr. KUDLOW. I think so. I think there is a great credibility problem left. It didn't happen last week, or last month. It has been building for many years. But there is an almost generic cynicism about the growth of Federal finance and the ability of the executive and the legislative branches to limit the growth of Federal finance.

Senator GORTON. Is your advice to the Congress to pass Senate Resolution 58, the balanced budget amendment?

Mr. KUDLOW. I am in favor of it, certainly, as a principle. In terms of the details, the administration has, of course, testified in favor of the bill, the amendment. We have not solved all the technical issues, but I think the amendment is a step in the right direction.

All these efforts are a step in the right direction: The budget; the balanced budget issue; and the credit budget issue. I just hope as we look at the financial market situation and the prospects for economic recovery that we spend as little time as possible patting ourselves on the back and as much time as possible moving ahead quickly to new and greater discipline in this process.

UNIFORM AND ACCURATE INFORMATION ON DEFAULTS

Senator GORTON. One of the ingredients that Congress needs in order to make better decisions on Federal credit activities is better information on defaults and especially that information which is comparable among various programs.

What action is the administration taking to include uniform and accurate information on defaults in its annual budget commission?

Mr. KUDLOW. Well, you asked me this question late last year, and I am afraid I have to give you much the same answer today as I gave you in December, and that is we don't have much to show yet, although there is a lot of work and study underway.

The Office of Management and Budget has been working with other agencies to develop better data. One of the problems here is the reporting system. I can't even say with any degree of certainty what the rate of loan default has become. We know it is rising in areas, and that is not surprising, because the same default rates are rising in the private sector credit, but I cannot tell you with any degree of precision.

All I can say is, we are working on it and studying it. It is a major management-oriented priority, but I am still empty handed with respect to specifics.

ADMINISTRATION SUPPORTS PROXMIRE BILL

Senator GORTON. The administration has endorsed the Percy-Mineta-Bethune bill, but I am not aware that the administration has a position on the Proxmire proposal on the budgetary treatment of the Federal Financing Bank or your position on Senator Levin's bill on the incorporation of loan guarantees into the impoundment control provisions of the Budget Act.

Can you comment either officially or unofficially on these two issues?

Mr. KUDLOW. Yes, I can comment officially.

We have indicated our support for the principle embodied in the Proxmire bill. There is no question that the bill raises an important issue with respect to off-budget outlays. I cannot find any difference between recorded budget outlays and recorded off-budget outlays in terms of their economic impact and their budget impact or the financing impact necessary to support them.

So the principle is fine. I would add, as I have in the past, that the biggest problem here is not so much the accounting principle as it is the programmatic foundation.

We have seen quite an expansion of off-budget spending. It will run close to $20 billion in fiscal year 1982, and will probably run uncomfortably close to $16 billion in fiscal year 1983.

It was only 4 or 5 years ago when it was less than half that amount. Here, too, we have the usual programmatic issue. Are these programs working? It is really only a handful of programs that comprise the bulk of the off-budget activity through the FFB, and what is the economic impact?

As far as the bill itself and the request to put the FFB outlays on budget, the administration has not yet taken a position on that specific legislation, so I will endorse the principle as I have in the past.

I will, however, add that the matter is under study right now and we will probably have a position on that very shortly.

Senator GORTON. Would you cover the Levin bill?

Mr. KUDLOW. We are still looking into the Levin bill. We just received it about 1 week or 10 days ago. It is a very interesting proposal and covers a lot of ground, some of which has been raised by Congressman Mineta's testimony. It is a complicated matter, and raises a lot of questions about the Budget Act itself. We will have to study the Levin proposal further before developing a position.

Senator GORTON. Under current practice, Federal expenditures to satisfy claims of creditors resulting from the default of a borrower to whom the Government has provided a guarantee are counted as new direct loans.

It seems that this practice makes the default somewhat more innocuous in theory than it is, in fact, and contributes to the low visibility of actual default rates. Do you have any comments on that practice?

Mr. KUDLOW. No. That is a very technical issue. I must confess that I haven't looked into that. I don't view that as the biggest problem we have. We can look into it and supply you information on it, but I don't really have a view.

CONGRESS SHOULD GO FORWARD WITH CHANGES IN CREDIT BUDGET

Senator GORTON. In summary, however, it is the position of the administration that it would be highly advisable for the Congress to go forward with changes in the credit budget outlined in the bills we have been discussing here for the last several months?

Mr. KUDLOW. I think so. The sooner we get the process questions down, the faster we can deal with the substantive policy-oriented problematic questions.

Senator GORTON. This is a very good way to close the Senate hearings.

Thank you very much.

The committee is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned, to reconvene subject to the call of the Chair.]

WRITTEN COMMITTEE QUESTIONS TO NANCY H. TEETERS, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, AND THE RESPONSES

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

January 21, 1982

NANCY H. TEETERS
MEMBER OF THE BOARD

The Honorable Slade Gorton
Chairman
Task Force on Federal Credit
Committee on the Budget
United States Senate
Washington, D.C. 20510

Dear Chairman Gorton:

I am happy to respond to your letter of December 17 in which you asked me a number of questions pertaining to federal credit programs. Your questions and my answers are presented below in the order in which you asked them.

1. Should one make the assumption that all federal lending is financed by borrowing? For what reason is this assumption made?

If one focuses narrowly on the process by which federal agencies make direct loans, it is generally accurate to say that they are financed by borrowing. Most of the funds loaned by nearly all on-budget and off-budget agencies come from one of three sources: (a) the issuance of new debt obligations; (b) a sale of loan assets out of portfolio which the agency guarantees--a transaction similar if not essentially the same as a secured borrowing; and (c) principal and interest payments on loans still held by the agency that were originally financed (mainly) out of borrowed funds.

Prior to the establishment of the Federal Financing Bank (FFB), the federal agencies issued their debt obligations or sold (guaranteed) assets directly to the public. Since the Congress established the FFB in 1974 to coordinate financing activities of the federal agencies and thus reduce the market congestion caused by individual agency borrowing, the agencies have for the most part financed their activities through the FFB. The FFB also extends funds to borrowers outside the federal government whose debt obligations have been guaranteed by a federal agency. This, in effect, converts these guaranteed loans into direct federal loans.

The FFB, while authorized to borrow in the market (up to $15 billion) has, except for a brief period at the outset of its operations, financed its activities by borrowing from the Treasury. The Treasury's loans to the FFB are made from the general pool of funds obtained from tax collections and borrowing in the market. But, since the agencies, in the absence of the FFB, would have been borrowing directly in the market, it seems reasonable to consider the Treasury's loans to the FFB as being financed solely by its issuance of debt. And, therefore, federal lending is financed by borrowing.

The intent of this question, however, would appear to go well beyond obtaining a review of the procedures used in accounting for federal credit programs. Of perhaps greater interest is how federal credit programs should be viewed from the perspective of the overall impact of the federal government on economic and financial conditions. In taking this broader perspective, it is helpful to note that, while direct loan programs have somewhat different implications for public and private balance sheets than guarantee programs, the credit assistance provided under both can have essentially the same impacts on the economy and financial markets. Both approaches can in some circumstances make it possible for a party to borrow more funds than he otherwise would or, in some cases, to borrow at all. Accordingly, both approaches produce changes in the allocation of credit and purchasing power in the economy.

Both types of federal credit programs, moreover, have the potential for affecting markets for goods and services, and coincidentally financial markets, in ways similar to general federal outlays financed by the issuance of Treasury debt. This generalization, however, requires two qualifications. First, for some credit programs, a substantial part of the private borrowing that is assisted would have occurred anyway. In such cases, it is not analytically correct to add, on a dollar-for-dollar basis, the volume of spending financed through direct and guaranteed loans to other federal outlays, or to add the volume of borrowing under federal credit programs to the volume of other federal borrowing. For example, a large volume of the loans arranged under the Federal Housing Administration's mortgage insurance program would, in the absence of this program, have still been borrowed and spent on housing.

Second, federal credit programs have different implications for the financial positions of those receiving credit assistance than do other federal activities. In particular, assisted parties end up with a debt and this presumably will affect consumption/savings decisions (in the case of programs assisting households) and investment decisions (in the case of those assisting businesses). And, the federal government ends up with an asset when it makes a direct loan or with a contingent asset (equal to the contingent liability it incurs) when it guarantees a loan. The extent to which the government's net wealth is affected by such transactions, of course, depends on the degree of likelihood of repayment of the loans, a degree that varies considerably from one credit program to another.

Because of these differences, the Congress would be wise to decide to establish a separate credit budget rather than a single comprehensive budget. At the same time, however, given that the impacts of some credit programs on the economy are, to a greater or lesser extent, quite similar to those of other types of federal outlays--particularly when these outlays are financed by Treasury borrowing--it seems clear that the Congress should subject both budgets to the same degree of scrutiny and discipline. Moreover, in the evaluation of individual programs, the Congress should follow procedures which enable it to compare and make trade-offs between direct outlays and federal credit assistance programs. It is encouraging that Congress is moving toward a full adoption of just such budget procedures.

2. Do all types of credit programs contribute equally to the deficit?

Under current budget accounting procedures, only direct loans of on-budget agencies contribute to the unified deficit, while direct loans of off-budget agencies--including FFB acquisitions of loans guaranteed by other federal agencies--add to total borrowing requirements. Debt obligations guaranteed by a federal agency--other than those acquired by the FFB--are not reflected in either of these traditional budget measures but commitments to make such guarantees are reflected in the new credit budget along with the direct loans of federal agencies.

Aside from the accounting aspects, federal credit programs and bond-financed Treasury outlays may have differential impacts on the economy and financial markets as noted in the answer to the previous question. For many purposes, it would be appropriate to consider only that portion of additional borrowing generated by federal credit programs as comparable to bond-financed outlays. In the absence of such an approach, adding together the federal credit programs and on-budget deficits would provide a misleading notion of the impact of the federal sector on the economy.

3. Do you think the type of crowding out in capital markets varies with the type of federal credit program?

Under the current operating procedures of the Federal Reserve, "crowding out" is a less germaine concept than "pricing out." The degree of crowding or pricing out varies with different types of federal credit programs. The distinction has to do not with whether credit assistance is provided by a direct loan or through a loan guarantee, but rather with the extent to which the program results in a volume of borrowing and spending by those receiving assistance that is greater than would otherwise occur. Those programs which give rise to little additional borrowing do not result in a significant crowding out. On the other hand, other federal credit programs which do encourage increased borrowing by selected individuals or firms clearly work to crowd out firms and individuals attempting to borrow without federal assistance. Federal loans or guaranteed loans tend to have a higher priority. Because of their greater security, guaranteed loans tend to be more attractive.

4. Does expansion of federal loan guarantees provide a net stimulus to the economy or simply redirect credit from non-guaranteed borrowers to guaranteed borrowers?

The impact of credit programs that result in greater spending and borrowing will depend not only on the degree of increase but also on the state of the economy. In recessionary conditions when there are generally slack credit demands in the private sector, credit demands that are expanded by credit assistance programs will have little effect of crowding out other borrowers. In circumstances of taut credit markets, on the other hand, federally assisted credit tends to crowd out borrowing that would otherwise be done by unassisted firms and households. Or to put this another way, credit (and thus purchasing power) is simply shifted from non-assisted to assisted borrowers.

5. Does the pattern of federal credit activities thwart the objective of monetary policy? How should credit policy and monetary policy be coordinated?

Federal credit activities do not thwart the objectives of monetary policy but can make the achievement of these objectives more difficult. At the present time, monetary policy is being directed to restore reasonable price stability in the economy. To this end the Federal Reserve is operating to to constrain over time growth of the total supplies of money and credit to a moderate, non-inflationary pace. Federal credit programs basically play an allocative role, enabling program beneficiaries to obtain some portion of total credit supplies by reducing the cost and increasing the accessibility of credit to them. By increasing the effective credit demands of some parties, the credit programs thus tend to increase total credit demands. Accordingly, these added demands do tend to put upward pressure on interest rates. It is important to take into consideration, of course, that many federal credit programs have been designed, at least in part, to assist certain classes of borrowers who are particularly vulnerable to tight credit conditions. Thus, from this point of view, and to the extent they are effective, the programs fulfill the objectives for which they were established.

With regard to how monetary policy and federal credit policies should be coordinated, it should be noted that federal credit programs basically are subject to the control of Congress in the same way as are federal outlays and taxes. And, indeed, particularly with the establishment of new budget procedures for federal credit programs, the Congressional budget decision process should endeavor to coordinate federal credit programs with other federal activities. Thus, the same arrangements used to coordinate general budgetary policy with monetary policy can also be used to coordinate federal credit policies with monetary policy.

I enjoyed meeting you on a more informal basis at DeGray State Park. In spite of the difficulties of getting out of there, I thought it was a productive meeting. I hope these answers prove helpful to you. Please let me know if I can be of further assistance.

Sincerely,

Nancy H. Teeters

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JAN 11 1982

Dear Mr. Chairman:

I am pleased to provide the enclosed answers to the questions which you submitted to me in connection with the December 10, 1981 Task Force on Federal Credit hearing.

I hope this information is helpful. Please let me know if I can be of further assistance.

Sincerely,

Roger W. Mehle

Roger W. Mehle

The Honorable
Slade Gorton, Chairman
Task Force on Federal Credit
Committee on the Budget
United States Senate
Washington, D.C. 20510

Enclosure

WRITTEN COMMITTEE QUESTIONS TO ROGER MEHLE, ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE), AND THE RESPONSES

1. Does the Administration make the assumption that all federal lending is financed by borrowing? For what reason is this assumption made?

Answer.

Generally, the Administration does not assume that all Federal lending is financed by borrowing. The Federal Government borrows to finance the deficit, which includes net lending but generally consists of Government spending (less tax and other receipts) for other purposes. In a year when there is substantial net lending there may well be a surplus in the total Federal budget, and there would thus be no net borrowing by the Government.

Yet, for the purpose of estimating the cost to the Government of making a direct loan, the Administration assumes that Federal lending is financed by Federal borrowing for a period comparable to the maturity of the loan. Current market yields on outstanding United States obligations with maturities comparable to the period of investment are the best measure of the cost to the Federal Government of financing an activity. While the Treasury does not enter the market to borrow a specific amount of funds for the period required to finance the activity, Treasury is compelled to have a comparably greater amount of debt outstanding for that period. Thus, the most appropriate measure of the alternative cost involved in financing an activity by the Federal Government is the current market cost of Federal borrowing for a comparable maturity.

2. Do all types of credit programs contribute equally to the deficit?

Answer.

Under current budget scorekeeping rules, net lending (i.e., the excess of loan disbursements over loan repayments) under on-budget direct loan programs contributes to the unified budget deficit. Net lending for off-budget direct loans contributes to the total Government deficit. Net lending under Federal guarantee programs is not scored in the budget totals. Over the long run, however, the net costs to the Government of all three types of loans are reflected in the unified budget deficit, including administrative costs, any interest subsidies, and any costs arising from loan defaults.

3. Do you think the type of crowding out in capital markets varies with the type of Federal credit program?

Answer.

As I indicated in my prepared statement, while the myth seems to persist that guaranteed borrowings are substantially different from direct Federal borrowings and involve less Government intervention in the marketplace, this is not so. Loan guarantees, like direct loans, entail interest rate subsidies, administrative costs and potential default costs to the government, and every dollar of Government guaranteed debt financed in the public marketplace is like Treasury borrowing to finance direct loans and has a similar negative impact on private credit markets and interest rates.

Would you say that the crowding out phenomenon increases with increased economic activity?

Answer.

The total volume of credit available in financial markets at any time is limited by a number of constraints, including the flow of savings and investment, and the constraints of monetary policy and the level of interest rates. The limited supply of credit available in the economy means that the increased demands of Federal credit programs add to pressures on interest rates and tend to raise interest costs for all borrowers, including the Federal Government. During periods of increased economic activity, private demands for credit rise. Thus, during these periods Federal demands on the credit markets should be especially curtailed to avoid putting upward pressure on interest rates and to make room for increased private credit demands.

5. Does expansion of Federal loan guarantees provide a net stimulus to the economy or simply redirect credit from non-guaranteed borrowers to guaranteed borrowers?

Answer.

The effect of Federal credit activity on the economy depends upon the extent to which Federal credit programs divert real resources in the economy, which, in turn, depends upon the degree of subsidy provided by the program. Where the subsidy is small or non-existent, such as under the basic FHA single family mortgage insurance program, it is likely that the program will induce little, if any, additional economic activity. Where the subsidy is substantial, such as the public housing bond program where the expectation is that the Federal Government will pay all principal and interest on the guaranteed loans, it is clear that the activity would not have been undertaken without the Federal credit assistance. In such cases, where loan guarantees stimulate new activities, the net effect on economic productivity and thus on real growth will depend on the extent to which the new activity stimulated by the Government will be more or less productive than other activities which might have been undertaken had the Government not preempted resources.

6. Does the pattern of Federal credit activities thwart the objectives of monetary policy? How should credit policy and monetary policy be coordinated?

Answer.

Given the limited supply of credit available in the economy at any time, an increase in Federal demand for credit makes achievement of monetary policy goals more difficult. During periods of restrictive monetary policy, an increase in Federal credit demands will require greater restraint on private credit demands in order to achieve monetary policy targets. While we acknowledge the independence of the Federal Reserve and its special relationship with the Congress, we also recognize the crucial role of the Federal Reserve in setting a firm monetary policy and providing an environment in which the Administration's goals of reducing inflation and encouraging economic growth can be achieved. Stable, moderate, and predictable money growth is required in order for these goals to be achieved. To facilitate coordination of fiscal, credit, and monetary policies, Secretary Regan and other Treasury officials meet regularly with Chairman Volcker and the members of the Federal Reserve Board. We are extremely pleased by the constructive and cooperative climate of these meetings.

Shipbuilders
Council of America
1110 Vermont Avenue, N.W. ■ Washington, D.C. 20005 ■ (202) 775-9060

February 10, 1982

Dear Mr. Chairman:

Many thanks for your letter of February 2, co-signed by Senator Metzenbaum, relative to your current hearings on Federal credit programs.

We can appreciate the Task Force's limitation on testimony, and, in an effort to be cooperative, we simply wish to endorse, for the record, the comprehensive statement submitted by Cecil M. Keeney, Chairman, Committee for Title XI Vessel Financing.

With the Committee for Title XI Vessel Financing, we have a commonality of purpose. Our views with respect to economic and budgetary effects of the Title XI financing guarantee program as authorized by the Merchant Marine Act of 1936 are compatible with those stated by Mr. Keeney, and we would like to be recorded accordingly.

With best personal regards always, I am

Sincerely,

Edwin M. Hood

Edwin M. Hood
President

The Honorable Slade Gorton
Chairman, Task Force on Federal Credit
Committee on Budget
United States Senate
Washington, DC 20510

The Small Business Coalition for Pollution Control

[BY MESSENGER]

President
Jack L. Schaefer
The Specialty Papers Company
Box 1031
Dayton, Ohio 45401
(513) 226-1300

Counsel
Randal C. Teague
Vorys Sater Seymour & Pease
1828 L Street, N.W.
Washington, D.C. 20036
(202) 822-8200

February 12, 1982

Senators Slade Gorton
and Howard M. Metzenbaum
Task Force on Federal Credit
Senate Committee on the Budget
Washington, D. C. 20510

Attn: Mr. David M. Nunny
Professional Staff Member

Dear Senators Gorton and Metzenbaum:

Pursuant to your February 2 letter, inviting The Small Business Coalition for Pollution Control to submit written testimony for inclusion in the permanent, printed record of the Task Force on Federal Credit's February 10-11 hearings on that issue, we forward herewith a Statement by the Coalition's president, Jack L. Schaefer.

We respectfully request this testimony and the informative attachments to it to be included in the permanent record.

The Task Force's and the Committee's attention to this issue is deeply appreciated.

Respectfully submitted,

Randal C. Teague
Counsel

RCT:ms
Att.

STATEMENT OF JACK L. SCHAEFER, PRESIDENT, SMALL BUSINESS COALITION FOR POLLUTION CONTROL

SMALL BUSINESS AND WHAT'S LEFT OF THE SBA'S POLLUTION CONTROL FACILITIES FINANCING GUARANTEES PROGRAM: A CASE STUDY IN WELL-INTENTIONED MOTIVES APPLIED DISASTROUSLY TO A SPECIFIC PROGRAM

Mr. Chairman and Members of the Committee:

You and the Committee's Task Force on Federal Credit are to be congratulated for holding these hearings. Their focus on the roles of Federal credit and loan guarantees and the benefits to the economy to be derived from them, as well as the dangers to that economy posed by any unnecessary reliance on other abuse of them, is crucial to determining what should now be done, how and on what timetable.

Few in business know the adverse impacts of the Federal Government's "crowding out" of available capital more than small businesses. Small business is usually the first driven out of the capital market and the last back in. It is the first hit by the high interest rates which inadequate capital produces.[1]

---

[1] The November 1981 report of the National Federation of Independent Business, "Report on Small Business in America's Cities," ranked problems posed by high interest rates as the number one problem among the small businesses surveyed.

The concern which we express here today is that summary policy objectives designed to reduce the Federal Government's crowding out of available capital and tax revenue losses to the Treasury may reach specific programs not intended to be reached or, if intended, without an adequate understanding on the part of those persons who formulated the policy objective of what the real consequences to those programs will be. These include consequences which undermine their other economic policy objectives: jobs creation, increased productivity and tax revenue generation. We believe this is the case here.

The Small Business Coalition for Pollution Control

I am Jack L. Schaefer, president of The Small Business Coalition for Pollution Control, on whose behalf this Statement is offered. The Coalition was organized last year to heighten the awarenesses of Congress, the Administration and the public on the alternatives before them in determining the future of the Small Business Administration's pollution control facilities and equipment financing guarantees program.

This Coalition represents the small businesses which have, on the one hand, been required to install pollution control facilities and/or equipment in order to meet pollution control objectives of the Government and which, on the other hand, would face either (1) noncompliance with the statutes, regulations, plans and orders reflecting those policies, or (2) a sale to a bigger business with more assets and borrowing leverage, or (3) insolvency and reorganization, if forced to over-leverage against net worth made lower by the borrowing, or (4) going out of business. I know this to be true because I am president of a small business, a printing company, The Specialty Papers Company of Dayton, Ohio. The company is an SBA loan guarantee applicant, and its officers and employees are aware of the almost unavoidable consequences of a failure by this Administration to act in a timely way to allow SBA to proceed with this program (1) at an annual authority level consistent with the law (P.L. 97-92, the FY82 Continuing Resolution) and (2) with the guaranteeing of tax-exempt bonds, a guaranteeing consistent with the statutes, their legislative history and six years' experience.

The Coalition is not a permanent trade association. If the issues associated with it go away, the Coalition expects to go away too. But, we will be intensely active until it does.

The Coalition is represented by Randal C. Teague, Counsel to the Washington Office of Vorys, Sater, Seymour and Pease, a Columbus, Ohio general civil practice law firm of national reputation in the relevant corporate, bond and environmental compliance areas.

The Issues

When the Coalition was organized, there were three issues. They were:

1. The level of FY82 annual authority to be apportioned to SBA for this program by the Office of Management and Budget;

2. A resolution of the tax status of the bonds the proceeds

to be used to finance facilities and equipment; and

3. Whether the personnel ceiling for SBA's Pollution Control Financing Section, also controlled by OMB, would be adequate to permit that Section to close on guarantees equal to the annual authority level.

We knew that if any link in this three-link chain broke, the SBA pollution control facilities guarantee program would be severely endangered.

These three issues remain. Only two things have happened: First, they have been more precisely sharpened and, second, this has been because OMB has acted by fiat as to the first and second issues and not at all as to the third. The Coalition and its members believe these unilateral OMB actions to be outside the law.

Briefly, what is this program?

History of the SBA Pollution Control Facilities Program

The Small Business Administration's pollution control facilities financing program is really a pollution control facilities and equipment financing program. It was authorized by sections 102-103 of the Small Business Investment Act of 1976 (P.L. 94-305, 90 Stat. 663, 15 U.S.C. 692, 13 C.F.R. 111) in order to assist small businesses both meet pollution control requirements and remain competitive.

That Act authorized SBA to guarantee up to one hundred percent of the payments due from eligible small businesses under qualified contracts for the planning, design, financing or installation of pollution control facilities and/or equipment. The program was, in short, designed by Congress to allow small businesses to obtain access to the tax-exempt bond markets for the financing of plant changes and equipment mandated by pollution control (air and water pollution control and solid waste management) regulation of the Government.

The current limit on a loan guarantee is $5,000,000 principal plus interest, and the average is $1,200,000. The maximum is 30 years, and the average is 20 years. It is the qualified contract which is guaranteed, and the applicant must demonstrate the need to overcome financing disadvantage to qualify. The applicant pays a guarantee fee of 3.5-percent times principal plus interest, less the escrow deposit of 3 monthly payments. In the event of default, payment is made from the escrow fund first, then from the fund created by the guarantee fees collected and the interest earned thereon. The $15 million revolving fund established by Congress at the beginning of the program has grown through the addition of these fees to over $30 million, and it is our understanding that the only defaults (2) in its history are being recovered by SBA through subsequent agreements with the defaulting small businesses.

The crucial need for the program has been reflected by the growth in applications received and loan principal guaranteed:

Year	Companies Assisted	Principal	Aver. Prin./Co.
FY77	12	$ 5.7 million	$ 475,000
FY78	14	9.9 million	707,143
FY79	45	41.5 million	922,222
FY80	77	98.5 million	1,279,220
FY81	66	99.9 million	1,513,636

It must be stressed here that the number of applicants measured against the limited available authority assures that this program is one of "last resort."

Why is this Government guaranteed financing necessary? Principally for two reasons:

1. Extensive facility and equipment expenditures are necessary to control air and water pollution and solid waste disposal in order to comply with Federal environmental policy objectives; and

2. Obtaining ordinary debt financing without SBA guarantees is nearly impossible because of the disproportionate cost of the equipment in relation to most small businesses' net worth and profitability and because the equipment itself generally has little value as collateral. Equity financing is generally not a viable alternative.

The Issue of FY82 and FY83 Authorities

The issue before this Task Force today is the first issue: The level of FY82 authority, for it is that level which enters the capital marketplace.

Other witnesses will place into the record of these hearings general information with respect to Federal credit and loan guarantees and detailed information with respect to particular programs. There are many. The recently released "Catalog of Federal Loan Guarantee Programs," Committee Print 97-10 of the House Committee on Banking, Finance and Urban Affairs, details approximately 65 guarantee programs.

If the law is followed, the SBA pollution control facilities loan guarantee program will constitute $250 million or approximately fourteen-hundredths of one percent of total Government guarantees in FY82. If the OMB apportionment of $150 million is followed, it will constitute only five-hundredths of one percent.

It should be noted here that the Federal Government's intrusion in the capital marketplace is not only by Federal credit and loan guarantees but also by its own borrowing for its own public debt purposes. The Administration is rightly concerned about this additional component of its crowding out of available capital, but many are left with the impression that the Administration's "crunch" on the credit and loan guarantee side is of greater interest to it than its concerns on the deficit borrowing side. One can even make a credible argument that the loan and credit guarantee "crunch" is a direct product of trying to indirectly offset the additional impact of its own borrowing, and by doing so it puts the burden of reducing the total Federal Government crowding out on the backs of the private sector and the productive economy rather than on the Federal Government.

This is no longer speculation. On January 14, 1982 the Coalition's legal counsel, Randal C. Teague, wrote a letter to the Assistant Secretary of the Treasury for Domestic Finance, Mr. Roger W. Mehle, Jr., setting forth arguments similar to those set forth in this statement and asking that Department to initiate a review of the application of its broad-reaching policy directives as to Federal credit and as to tax-exempt IDBs to this particular program. By letter of February 4, Assistant Secretary Mehle responded. In that response is a particularly revealing paragraph:

> "Let me emphasize the reasons this Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind an obligation that is exempt from Federal taxation would create a security which would be superior in the market to the direct obligations issued by the U.S. Treasury. The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations directly. It would therefore be contrary to the spirit of that Act to authorize the issuance of tax-exempt securities that are backed by the credit of the Federal Government." (Emphasis added)

Several observations and several queries are in order.

First, we find it interesting that the spirit of a 1941 Act is given precedence over the letter of the Small Business Investment Act of 1976 (Public Law 94-305) and the legislative history of the Joint Resolution making further continuing appropriations for the fiscal year 1982 (Public Law 97-92). Apparently, this Administration is not familiar with the relevant canons of legislative construction, to wit: that the letter of the law takes precedence over the spirit and that, when there is conflict between legislative enactments or legislative intents, the most recent in time takes precedence.

Second, one has a feeling that the "spirit" derived from the Public Debt Act of 1941 was an afterthought, sought and found subsequent to a decision in order to justify it, for this "spirit" was not an impediment to the first five years of this program.

Third, can the Government of the United States be so concerned about its credit and anticipated FY82 and FY83 borrowing that it believes guaranteed tax-exempt pollution control bonds are marketplace threats to that borrowing?

Mr. Chairman, we ask that Mr. Teague's and Assistant Secretary Mehle's letters be incorporated as part of this statement.

What else has happened to this program's FY82 annual authority?

In summary:

o Legislation (S.580) was introduced to increase the annual authority to $250 million, and a hearing of the Senate Committee on Small Business was held on May 7, 1981 at which time the Administration opposed the increase and reiterated its intention to reduce the annual authorizations from $110 million to $100 million in FY81 and from $125 million to $95 million in FY82.

o The Budget enacted in early August as Public Law 97-35 authorized the SBA Administrator to proceed at an FY82 annual authority level of $250 million.

- The Departments of State, Justice and Commerce Appropriations legislation (H.R. 4619) enacted by the House and sent to the Senate provides for a $250 million authority, and, further, the chairman of the relevant Senate Committee on Appropriations subcommittee, Sen. Lowell P. Weicker, who is also the chairman of the Senate Committee on Small Business, has stated on the Senate Floor his support for that House-passed level.

- On November 5 the Administration announced an additional program to reduce Federal loan guarantees in FY82 by $20.3 billion, from $181.4 billion to $161.2 billion. SBA loan programs in the aggregate were reduced $1.0 billion or 16%. [I will return to this November 5 announcement.] Notwithstanding these enactments and statements of Congressional intent, the Administration, through OMB, then apportioned only $40 million for FY82 First Quarter.

- The Congress then set forth a unanimous intent in the Floor considerations of the mid-November Continuing Resolution that the FY82 authority level was to be no less than $175 million. This legislation was vetoed by the President on other grounds.

- The Congress thereafter set forth a unanimous and again clear intent in the Floor considerations of the subsequent Continuing Resolution (House Joint Resolution 370) that the FY82 authorization level was to be no less than $250 million, the level originally set forth in S. 580 and Public Law 97-35. Anyone doubting the unmistakable clarity of that intent should read the colloquy of Senators Hayakawa and Weicker at page S14989 and the colloquy of Senators Garn and Levin at page S14994 in the Congressional Record of December 10, 1981. This Continuing Resolution was signed by the President. It is Public Law 97-92.

o That law notwithstanding, the Administration through OMB then apportioned $150 million in FY82 authority for the program and with a proviso which crippled it. The proviso prohibited the guaranteeing after December 31, 1981, of any loan resting upon a bond which was tax-exempt. This is a prohibition without statutory, legislatively historical or experiential bases. The attack on tax-exemption was, as it remains, another Administration objective, and it was attached to the apportionment document with a kind of administrative fiat atypical of a government of laws.

o Lastly, in the "Proposed Supplementals and Rescission Proposals" section of the Appendix to the Budget for FY83 at page III-41 we find the Administration's request, as follows:

> "Pollution Control Equipment Contract Guarantee Revolving Fund
>
> "(Appropriation language now requested, existing legislation)
>
> "During fiscal year 1982, within resources and authority available, total commitments to guarantee shall not exceed $150,000,000 of contingent liability for principal.
>
> "This proposal would increase the request for new 1982 guarantee commitments which offsets a small portion of the reduction in the commitment to guarantee loans for the

Business Loan and Investment Fund."

This depiction leaves someone not knowledgeable in the recent history of this program not only with the wrong impression that it is the Administration which has requested an increase in guarantee commitment but also with not even a hint that a crippling proviso has been attached to that authority.

This is the status of the program today. Unless the proviso is rescinded from the apportionment document, the program is dead. Soon, the small businesses may be.

It has seemed to me from the outset of this unnecessary confrontation that there was a more rational way to meet Administration's objectives if it really wanted to kill the program. That is to phase out the program quickly but only after those applications already pending when the rules were changed in the middle of the game are acted upon, favorably or unfavorably, based on their particular merits and the rules as they existed at the time of the application being made.

What's Wrong with the Administration's Attack on this Federal Guarantee?

Why has the Administration so strongly opposed this Federal guarantee?

Part of the answer has now been given to us by Assistant Secretary Mehle.

Another part of the answer is found, I believe, in the November 5 White House's Office of the Press Secretary "Fact Sheet on Federal Credit/Loan Guarantee Reduction," and I quote:

"The President today announced a program to reduce new Federal loan guarantee commitments for FY1982 by $20.3 billion, from $181.4 billion to $161.2 billion. The loan guarantee reductions are a part of the President's effort to relieve pressure on interest rates and to open the way for sustainable and non-inflationary economic recovery.

"* * * the President's credit reduction proposal is designed to:

"o Dampen inflation expections and lower interest rates.
"o Provide the financial market equivalent of a $20 billion reduction in budget outlays * * *.
"o Curtail the effects of government credit preemption from legitimate private enterprise.
"o Improve prospects for the expansion of productive investment and the recovery of economic growth.
"o Facilitate the appropriately restrained conduct of monetary policy.
"o Represent the first major effort to place substantial restraint on the off-budget explosion of Federal credit demand.

"* * * The Small Business Administration provides credit assistance to small businesses through its * * * 100% indirect guarantee of State pollution control bonds. Under this program, States issue tax-exempt pollution control equipment bonds and the SBA guarantees repayment of loans made to small businesses from the bond proceeds.

"The nearly $1 billion loan guarantee reduction (in SBA's total loan guarantee programs) planned by the President, a 20% reduction below the FY 1982 estimate of slightly less than $5 billion, will, as part of the economic program of lower tax rates, regulatory relief, and anti-inflationary monetary policy, afford more assistance to a wider variety of small businesses than the SBA programs, which focus on only a few. For instance:

> " * * * The reduction in guarantee assistance will not have a significant adverse effect on SBA's ability to serve as a lender of last resort. It will merely eliminate assistance to those firms at the margin, i.e., those that could obtain credit without Federal assistance and those that would probably never become competitive even with Federal assistance."

Several comments are in order.

Most small businesses support the President's economic recovery program of reduced Federal spending, reduced corporate and individual taxes, reduced deficits and the crowding out of available capital and the inflationary pressures which deficits can generate, reduction in excessive and unnecessary regulation, and expanded export opportunities. I would think the percentage of small businesses represented by the Coalition which support this economic recovery program would be little, if no, different from the percentage of small businesses as a whole.

The Coalition believes, however, that the November 5 OMB policy directive, as applied to the SBA pollution control facilties financing guarantee program, will continue to have consequences which may not, or should not, have been intended by the Administration.

We know that the concluding paragraph in the quoted sections of that November 5 Fact Sheet is simply wrong. Firms which have applied under this program have applied to SBA as, indeed, the lender of "last resort." Given the competition for these guarantees and the inadequate levels of annual authority, a small business would have known that it would not have reached "the top of the stack" unless it had exhausted private sector loan opportunities. Furthermore, it is not that a small business is marginal in the absence of indebtedness necessary to bring its plant into environmental compliance, it is, rather, that indebting itself further and substantially in order to assure that compliance is what makes the business either marginal or more marginal.

What the Administration is really articulating here is that Federal loan guarantees create "market distortions." It has failed to recognize something as equally important: So, too, do the requirements for expenditures to meet pollution control regulation by the acquisition and installation of generally non-productive assets. As long as this Government's policy on the one hand is to have such pollution control reuglation, its policy on the other hand must be to assist businesses without private sector loan alternatives to finance the facilities and equipment required, and this means both the guarantee and the tax-exempt bond.

The Administration ignores something else just as egregiously. Small businesses going out of business will have adverse tax revenue loss and budgetary cost impacts too. Reduced corporate taxes paid and reduced Federal payroll taxes paid on one hand, and increased unemployment and other benefits on the other. Such economics is not only bad economics; it is also bad politics.

What Is To Be Done?

The questions today are, whether this SBA program should be effectively abolished by the broad sweep of the overall Administration plan and, if not,whether Congress intends to direct the Administration's attention to this program in a way which will end OMB's debilitating attack on small businesses and effective pollution control.

We believe that Congress must insist unequivocally that OMB proceed with $150 million in FY82 and $250 million in FY83 and in both years without the existing proviso proscribing reliance on tax-exempt bonds. That proviso now threatens the program's future as severely as does the restriction on annual authority; in some ways, even more so.

Summary

The Coalition believes OMB must allow SBA to proceed without this proviso. The case for this position is clear; the merits of this program are with it:

- The program actually makes money for the U.S. Government.
- The program has a nearly pristine actuarial integrity.
- The program does not interfere with capital markets.
- The program does allow equal access by small business to those capital markets.
- The program constituted less than 1% of the small IRB issues in FY81.
- The program has public benefits, particularly pollution abatement which are disproportionately high, compared to other IRB-financed projects.
- The program has one of the smallest administrative staffs on record.

- The program is funded with private sector funds, only guaranteed by the Federal Government.
- The program has benefited small businesses in more than thirty States, representing over 20,000 jobs.

The plea of this Coalition is more directed at the Administration than it is at this Congress, for the latter knows the merits. We hope the Administration comes to know them and to this end many of the small business applicants have joined in sending a letter to the President which we offer here to conclude our testimony.

The help of this Task Force and this Committee is crucial to assuring the right Administration response.

The Small Business Coalition for Pollution Control

President
Jack L. Schaefer
The Specialty Papers Company
Box 1031
Dayton, Ohio 45401
(513) 226-1300

Counsel
Randal C. Teague
Vorys Sater Seymour & Pease
1828 L Street, N.W.
Washington, D.C. 20036
(202) 822-8200

January 14, 1982

Hon. Roger W. Mehle, Jr.
Assistant Secretary for Domestic Finance
Department of the Treasury
Washington, D. C. 20220

Re: SBA Pollution Control Facilities Financing Guarantee Program
Taxable vs. Tax-Exempt Bond Issues

Dear Secretary Mehle:

The Small Business Coalition for Pollution Control was organized in 1981 to support the policy objectives of the Administration with respect to small businesses and to represent their interests before the Government in the referenced program. The Coalition has been involved actively in recent months in monitoring negotiations between OMB, Treasury and SBA with respect to the FY82 and proposed FY83 annual authority ceilings for this program and the terms and conditions attached thereto.

As you know, a compromise was reached during the closing hours of FY82 First Quarter, a compromise reached between OMB and SBA, the former with the advice of Treasury on one component of that compromise. The compromise is in two parts: the annual authority ceiling, which will be $150 million in FY82 and FY83, Public Law 97-92 notwithstanding, and the proviso requiring that the FY82 authority not closed as of the approximate date of the compromise and all the FY83 authority be available only for taxable bond issues. Because you have been involved in both the Federal loan and credit guarantees and the IDB tax exemption issues, we felt it particularly important to bring several matters to your attention.

This SBA program came into being for only one reason: small businesses could not obtain commercial financing of the expenditures required to comply with Federal air and water pollution control and solid waste management policies and orders without Federal guarantees of the bonds the proceeds of which are used for such facilities and equipment and without the added attraction within the bond marketplace of the tax-exemption.

These expenditures are compelled by Government policy; in the absence of that policy, the expenditures would not be made and the financing sought. If Federal loan and credit guarantees are a financial marketplace distortion, so too is the Government requirement that essentially non-productive control equipment be installed at great expense.

The tax-exemption of the bonds is compelled by the reality that the absence of that exemption would make the bonds, even aggregated, not marketable. If tax-exempt bonds distort the capital pool, it is because the capital sought is mandated by Government environmental policy. If there is fear, well founded in our opinion, that tax exempt bond issues cause tax revenue losses at a time when budgetary and monetary policy require reduction of those losses, it must be forever borne in mind in looking at this particular program that those losses are far less than the corporate income tax and personal income tax losses which are occasioned when the small businesses close down because the financing is not available.

This latter point is not an allusion to what might happen. Rather, it is a statement of what has happened. When the Administration put this SBA pollution control facilities financing guarantee program in abeyance in the Spring of 1981, there were better than 100 applicants. Some withdrew their applicants, hoping to persuade the environmental enforcement authorities that it was the same Government which had frustrated these companies abilities to comply with environmental standards. But something else, much more dramatic happened: some of these small businesses went out of business. The Coalition has compiled the names and statistical data on those companies.

Before one rushses to say that those small businesses which went out of business must have, therefore, been so marginal that they would not have survived anyway, reflect on the experiential history of this particular program: in its six years, there has never been a default not recovered by SBA. There have been only two defaults at all. There simply is no other Federal loan or credit guarantee program which has a default rate of less than one-fourth of one percent which has also then recovered all of the defaulted payments.

Our plea to you: to recognize the particular circumstances associated with this particular program, including that history and including why these small businesses need the Federal guarantees and the tax-exemption of the financing bonds, and to then do two things: (1) inform OMB, that is Lawrence Kudlow, that Treasury has no objection to rolling back the proviso requiring the remainder of the FY82 $150 million and all of the FY $150 million be available for only taxable issues, and (2) informing those within Treasury involved in the formulation of the Administration's position on the forthcoming Congressional hearings on industrial development bonds that, irrespective of what broader policies are sought, the tax-exemption for IDBs used for pollution control facilities under either IRC §103(b)(6)(E)-(F) solid waste and air and water pollution control facilities exemption or the IRC §103(b)(6)(A) small issue exemption ought to be preserved. We reference IRC §103(b)(6)(A) small issue exemption because a private sector business must use that exemption, rather than either IRC §103(b)(6)(E) or (F) because the latter must be for public purpose and other tests which a private corporation cannot meet. The entire history of this SBA program has been one of using bonds under IRC §103(b)(6)(A).

The difference which taxable bond issues and tax-exempt bond issues have on these small businesses has been set forth in a recent letter to us from H. Robert Fuller of the First Wisconsin National Bank in Milwaukee, one of the four principal financial institutions involved in this program. The other three are Bank of America, Blythe Eastman out of the San Francisco office and McDonald & Co. investment bankers in Cleveland.

My only quarrel with the First Wisconsin depiction of the financial implications of the alternative between taxable and tax-exempt is that the applicants with which we are working indicate that the differential is closer to 4.25%, some 425 basis points.

Your attention to this matter and your involvement in its resolution would be very much appreciated.

Sincerely,

Randal C. Teague

RCT:ms
Enc.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

February 4, 1982

Dear Mr. Teague:

I am pleased to respond to your letter regarding the SBA pollution control facilities guarantee program.

In the last decade, rapid growth of Federal credit activity has had serious effects on the Nation's economy and on financial markets. For this reason, rigorous control over Federal credit programs has been and continues to be an important part of the President's budget reform plan. Greater control of these Federal programs is being accomplished by reducing their size and scope and by adopting legislative and administrative actions to decrease their impact on the capital markets.

In this regard, the Administration has maintained strong opposition to Federal guarantees of tax-exempt obligations, such as those obligations issued in conjunction with the SBA pollution control guarantee program. In a March 23, 1981 message to Congress, the President expressed his general opposition to federally-guaranteed tax-exempt obligations and the April 1981 "Additional Details on Budget Savings" specifically criticized the SBA pollution control guarantee program in this regard. The decision reached by OMB to only provide loan guarantees under the SBA pollution control program for taxable bond issues in fiscal years 1982 and 1983 results from this position.

Let me emphasize the reasons this Administration is strongly opposed to Federal guarantees of tax-exempt obligations. Placing the credit of the United States behind an obligation that is exempt from Federal taxation would create a security which would be superior in the market to the direct obligations issued by the U.S. Treasury. The Public Debt Act of 1941 prohibits the Federal Government from issuing tax-exempt obligations directly. It would therefore be contrary to the spirit of that Act to authorize the issuance of tax-exempt securities that are backed by the credit of the Federal Government.

Moreover, since the tax loss to the Treasury greatly exceeds the interest savings to the issuer of tax-exempt obligations, Federal guarantees of tax-exempts are a most inefficient means of providing Federal assistance.

The Administration is also concerned with the adverse effects of tax-exempt guarantees on the municipal market. Federal guarantees of tax-exempts create a security which is superior to all other tax-exempt securities issued by State and local government entities. Consequently, such guarantees add to the pressures on the municipal bond market, crowd out other, less creditworthy municipal borrowers, and increase the borrowing costs of all municipal borrowers.

I hope this information is helpful.

Sincerely,

Roger W. Mehle

Roger W. Mehle

Mr. Randal C. Teague
Vorys Sater Seymour & Pease
1828 L Street, N.W.
Washington, D.C. 20036

The Small Business Coalition for Pollution Control

President
Jack L. Schaefer
The Specialty Papers Company
Box 1031
Dayton, Ohio 45401
(513) 226-1300

Counsel
Randal C. Teague
Vorys Sater Seymour & Pease
1828 L Street, N.W.
Washington, D.C. 20036
(202) 822-8200

February 12, 1982

The President of the United States
The White House
Washington, D.C. 20500

Dear Mr. President:

We are small businesses whose abilities to provide jobs, produce goods and services, pay taxes and protect the environment have been consciously undermined in recent months by your Office Of Management and Budget's virtual destruction of the Small Business Administration's pollution control facilities and equipment financing guarantee program.

This letter is an urgent plea that you direct OMB to withdraw the unnecessary and probably illegal requirement it attached to the recent SBA apportionment document - that none of the remaining FY83 authority can be used to guarantee tax-exempt bonds. Those are the only bonds really available in the marketplace for financing these facilities and equipment.

Experts in this financial field are convinced that "taxable only" financing will effectively destroy the ability of numerous small businesses to finance compliance with government mandated pollution laws.

There is a profound inconsistency in the Government's administration of its environmental laws, and we are the small businesses caught in the middle of that inconsistency. On the one hand, we are being required to install environmental protection facilities and equipment to meet still-stringent EPA rules, and on the other hand, the OMB requirements eliminate the only effective means of obtaining loans required to install those facilities and equipment. Without this SBA program of "last resort" small businesses will be forced into noncompliance with environmental protection statutes, regulations, plans and orders. Or, into forced sales to bigger businesses with larger assets and borrowing leverage. Or, into insolvency if forced to overleverage against usually low net worth, because the uniqueness of these facilities and equipment leaves them without significant collateral values. Or, into shutdown.

We measure those dire, yet realistic, consequences against the experience of this program, SBA's most successful. It is that success which shows the lack of knowledge or interest at OMB.

No one in business knows the adverse impacts of the Federal Government spending and taxing and over-regulating more than a small business. Small businesses are the first hit by inflation. They are the first hit by crowding out and high interest rates. They are usually the first into economic slumps and the last out. This is why most small businesses, including those within the Small Business Coalition for Pollution Control, support your economic program of reduced spending, reduced corporate and individual income taxes, and reduced deficits. We support your attack on the crowding out of available capital and the inflationary pressures those deficits can create. We, too, seek reduced regulation and expanded export opportunities. But, OMB's broad policy objectives produce unintended consequences when applied to this SBA program.

OMB contends that the annual authority for this program must be rolled back to reduce Federal loan and credit guarantees in the capital marketplace. OMB contends, further, that the requirement prohibiting the program's association with tax-exempt bonds is necessary to prevent tax revenue losses.

OMB is wrong. This program constituted less than one percent of the small industrial revenue bond issues in 1981. It does not interfere with markets. The program has a nearly pristine actuarial integrity, with the only two defaults in its history now being recovered by SBA. The program actually makes money for the Government; its initial $15 million revolving fund has grown to over $30 million by the accumulation of the 3.5% fees paid by the applicants, and interest on that fund more than pays for all administrative costs. The program is funded with private sector funds; it is only guaranteed by the Government. The program has public benefits, particularly pollution abatement. Most importantly of all, it has benefited small businesses in more than 30 States, representing more than 20,000 jobs. If continued, the program will benefit many thousands more.

Mr. President, the "distortion" this program creates in the financial marketplace is miniscule compared to the real distortion caused by the Government requiring us to spend hundreds of millions of dollars on essentially non-productive facilities and equipment. Further, the tax revenue losses from tax-exampt IRBs are miniscule compared to the real tax revenue losses which will result if we have to close our businesses and lay off our employees. Or, if we can't expand productive capacity. Absent a continuation of this program, as it existed prior to OMB's attacks upon it, that may happen to many of us. Bonds for our purposes simply cannot be marketed in the absence of the tax-exemption and the Federal guarantee.

Our case is clear. The merits of this program speak for themselves.

We ask you to direct OMB to reverse its unilateral actions and to do so before the matter worsens.

Respectfully requested,

Jack L Schaefer

Jack L. Schaefer
THE SPECIALTY PAPERS COMPANY
Dayton, Ohio

Steve Milter
NATIONAL BRIQUETTE CORPORATION
East Chicago, Indiana

Robert E. Embry
Baum Gardener Oil, Inc.
ENERGY RESOURCES,LTD.
Baltimore, Maryland

Robert Speach
ENV, INC.
Long Beach, California

James D. Lightbody
PHILWAY, INC.
Ashland, Ohio

Frank E. Smith
F. E. SMITH CASTINGS, INC
Kingsford, Michigan

Fred Davino
PLATING FOR ELECTRONICS, INC.
Waltham, Massachusetts

Carl Hornby
ENVIRONMENTAL WASTE CONTROL, INC.
Inkster, Michigan

Craig Caine
AMERICAN FLY ASH COMPANY
Des Plaines, Illinois

Dennis O'Meara
OMEGA CHEMICAL CORPORATION
Whittier, California

Les A. Liman
DOWNHILL PICK-UP
Steamboat Springs, Colorado

J. E. Droege
ELECTROFILM, INC.
Valencia, California

Anthony L. Torrance
OPTICAL SCIENCES GROUP
Petaluma, California

Aubrey Burer
CHEMTRONICS
El Cajon, California

Larry Winget
Gary L. Robbins
VENTURE INDUSTRIES CORPORATION
Fraser, Michigan

W. O. Larson
M. F. Ludowese
LARSON CONSOLIDATED, INC.
Grafton, Ohio

Lewis Lakin
A. LAKIN & SONS, INC.
Chicago, Illinois

Harvey Scholten
RIVULET HURST DAIRY
Holland, Michigan

Leroy Wurst
HURON CASTINGS COMPANY
Pigeon, Michigan

Paul J. Keating
John A. DelRossi
P. J. KEATING COMPANY
Fitchburg, Massachusetts

Donald Schulz
NATIONAL METAL FINISHING
COMPANY
Springfield, Massachusetts

STATEMENT OF EBEN M. GRAVES, JR., CHAIRMAN, E. M. GRAVES & CO., INVESTMENT ADVISORY, INC.

Mr. Chairman, my name is Eben M. Graves, Jr., I am chairman of E. M. Graves & Co. Investment Advisory, Inc., a Connecticut based SEC registered investment advisor to corporate pension funds. My company is believed to be the first pension fund manager to invest in federal loan guarantee securities originated through local lending banks, guaranteed by a federal agency that collects a 1% guarantee fee and sold to pension funds we manage through a secondary market. The interest rate on these federal loan guarantees is determined by the free market supply/demand mechanism. Fixed rate paper is pegged to the Government National Mortgage rate and variable rate paper is pegged to the New York prime rate of interest.

The overall role of federal loan guarantee programs in the capital markets is to provide a government guarantee on loans originated and priced in the private sector. By providing a government guarantee, local lenders(small banks and small insurance companies) can make longer term capital available to small and rural businesses. These federal loan guarantee programs largely provide through local lenders the only sources of term capital to small and rural businesses.

I illustrate with an example: Say John Doe has a small manufacturing plant in Oklahoma that needs to build a new warehouse and buy some new trucks. He goes to his local bank which is a small bank with a loan request for a 20 year mortgage on the proposed warehouse and 10 year loan on the trucks. The local banker says, "Well John, we really don't like to make 20 year mortgage loans or 10 year equipment loans. Couldn't you get along with a 1 year loan that we might renew next year if your business is still good and your financial statements look alright?"

John Doe can't live with a short term bank loan. He has to have a long term loan matched to the life of the new capital assets he needs to purchase for his business which currently employs 20 people. If he gets the loan on the terms that he can repay he will employ 5 more people.

Doe looks rather glumly at the banker. Then the banker says, "We could make this loan under either the SBA or FmHA Business and Industry loan program. It will be an SBA loan if you don't need more than $500,000. However, your total loan request is for $1,200,000. Let me call FmHA and see if you would qualify." The call is made. It appears that Doe's business qualifies.

Doe is puzzled and asks the banker why he would lend long term debt capital under the FmHA B&I guaranteed loan program, when he wouldn't lend a dime conventionally without a federal loan guarantee.

"Well John," the banker answers, your loan will probably be guaranteed up to 90%. When the funds are disbursed to you I, the bank, can sell the guaranteed portion of your loan into the national secondary market and recoup 90% of the funds I lent you. This allows me to make a larger than ordinary loan to you. Remember, we are only a little country bank. Also, I can make a long term loan to you, one that matches your ability to repay. To get the government guarantee you have to satisfy their credit requirements which are as stringent as those imposed by our own credit committee. You will also have to pay a 1 percent one time guarantee fee. This is paid direct to the FmHA. The interest rate I charge will be competitive with other market interest rates. The rate will be determined by competitive bids received from the secondary market sources. The rate you will pay will be a half to three quarters of a point higher than the market rate on a Government National Mortgage Security. The bank will keep one-half percent of the rate you pay on the guaranteed portion of the loan as a servicing fee. We will continue to collect interest and principal payments on your loan and pass through to the pension fund purchaser the balance of interest and principal monthly".

"If there was no secondary market for these FmHA and SBA loans, we could not lend you long term capital to expand your business. The secondary market is a free system that simply and efficiently allocates capital saved in the pension system back into investment in small and rural American business."

"The reason the secondary market works is that the government guarantees and charges for that guarantee on your loan. When your loan goes into the secondary market there are four beneficiaries:

"(1) You, the borrower, get term capital you normally could not get.

"(2) A small country bank like us, can make a big loan, a loan we normally could'nt make to you a valued local business.

"(3) The nations pension funds get a full, faith and credit obligation with an interest rate competitive with corporate bonds.

"(4) The American taxpayer doesn't have to pay a subsidiary for you get this loan. You, the borrower, paid the government for the privilege of getting a federal loan guarantee. You paid 1% of the proceeds of the loan. If less than 1% of all borrowers go broke around the country, the U.S. Treasury makes money."

Borrower Doe says, "You mean that the government guarantee makes the secondary market possible?"

Banker: "Absolutely. The government guarantee makes your loan a safe investment, one of the safest high yeilding investments a pension fund could purchase." Best of all, states the conservative banker, "you and I, the taxpayers, don't get hit with increased cost of the federal budget in our taxes."

"How many FmHA Business and Industry Loans are outstanding?", asks borrower Doe.

The banker replies, "There are currently 3,546,397,621 FmHA B&I guaranteed loans currently outstanding. All these loans were made by small rural banks in 50 states like us. Ninety-seven percent were sold into the secondary market. This was a God send in that we could not have made the loans otherwise. Of the $3.5 billion worth of loans made, 1.16% defaulted. However, when you subtract the $31,917,578 collected in guarantee fees from the default figure ($41,014,000), you get a net loss figure of $9,096,422. This is the real cost of the FmHA B&I program. . . The cost to you and me as taxpayers. It represents .26% of the total $3.5 billion in loans made.

"That doesn't sound like much money when you look at the really wastefull direct loan and subsidiary programs the government sponsors", states John.

"It isn't any real money at all arrayed against the size of the overall federal budget. In fact, if the guaranteed fee was raised by FmHA to 1½%, the program would actually make money."

"If you look at the amount of new jobs created or saved, a very hard case can be made that the FmHA, B&I and SBA section 7A guarantee loans actually do make money. Every new person going into the work force pays taxes. Every person who has a job saved doesn't go on unemployment of welfare or need government assistance."

The Banker continues, "the $3.5 billion in FmHA B&I loans created or saved 273,134 jobs in rural America. The cost per job was $33.30. This was the lowest cost per job on any federal loan guarantee program", states the banker.

"Gee, I guess the new Republican Administration is using the FmHA B&I loans program as the example of supply side economics and how a well administered federal loan guarantee program priced and run through the private sector allocating capital to creditworthy concerns ...I guess the new administration is pushing programs like this."

"No John," replied the banker, "the Office of Management and Budget has tried to completely eliminate funding of the FmHA B&I program. If the current funding of $652,280,250 isn't restored to the $1 billion level, I'm afraid we can't make your loan. Instead of expanding your business and employing more people, you may have to cut back and lay some people off. You might try SBA, their budget is only being cut $1.2 billion or 25% in 1982. They may have some money left."

The borrower is silent. The banker resumes his rather dreary soliloquy, "The worst thing that these budget cuts will accomplish is to kill the secondary markets which depend on certain levels of supply of paper to fuel the pension funds' and savings institutions' purchasing interest. The secondary market, along with the passive government guarantee, is what really has been recycling savings capital into investment capital. It's really a shame. Instead of cutting these pure secondary market programs, the Congress and administration should have gradually increased them and eliminated the direct loan and subsidiary programs and used the interdepartment savings to increase FmHA B&I to the $4 billion budget level and leave SBA-Section 7A loans at the $4 billion level. No, John, I'm afraid that when they started cutting, they really didn't look too carefully at what they were cutting." Now that we are in the recession with unemployment at 9% and rising, we really need these federal loan guarantee programs that provide the only viable source of term capital to small and rural business. Small Business represents 90% of American business in absolute numbers, and employs 85% of the American people. The Reagan administration, has it seems, completely abandoned small business - eliminating the source of term capital.

BIOGRAPHICAL BACKGOURND ON EBEN M. GRAVES, JR., COMPILED FROM ROSTER OF NOTABLE CONNECTICUT BUSINESS OWNERS AND WHO'S WHO IN AMERICA

Education: Mr. Graves graduated from Westminister School in 1959 and The University of Pennsylvania in 1963 with honors. He headed the student judiciary committee, the dean of men's committee on discipline and won five varsity letters in football and lacrosse. Mr. Graves earned a masters degree in Business Administration, started at the Wharton School of Finance and Commerce and finished at New York University Graduate School of Business.

Military: Mr. Graves was a Lieutenant in the U. S. Army Security Agency attached to the 101st Airborne Division from 1963-1965.

Business: Mr. Graves joined Drexel Burnham's Investment Banking Department in 1968 and rose to be vice president in fixed income sales in 1975.

Mr. Graves started and headed the Federal Financing Department of Merrill Lynch Pierce Fenner and Smith in 1975.

He founded his own Connecticut based investment management firm in 1976. He is an expert on the federal loan guarantee security, priced and sold through the secondary market.

Affiliations: President's Council on Small Business, Former Chairman of Federal Loan Guarantee Dealers Association, Connecticut Council on Small Business, Sustaining member of the Republican National Committee.

Articles and books: "The S.B.A. and FmHA Loan Programs" cc 1976. "A Totally Unique Approach to Fixed Income Management." "Beyond Immunization in Bond Management." cc 1981.

National Council of Farmer Cooperatives
1800 MASSACHUSETTS AVENUE, N.W. • WASHINGTON, D.C. 20036 • TELEPHONE (202) 659-1525

Senator Slade Gorton
Chairman, Task Force on Federal Credit
Senate Budget Committee
6202 Russell Senate Office Building
Washington, D.C. 20510

Mr. Chairman:

The National Council of Farmer Cooperatives wishes to submit the following statement for the record of the February 11 hearings before the Task Force on Federal Credit of the Senate Budget Committee.

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes 117 regional marketing and farm supply cooperatives, the 37 banks of the Farm Credit System and 31 state councils of farmer cooperatives. National Council members handle practically every type of agricultural commodity produced in the U.S., market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. More than 80 percent of U.S. farmers are affiliated with one or more cooperatives. The National Council represents about 90 percent of the more than 6,700 farmer cooperatives in the nation, with a combined membership of about 2 million farmers.

Mr. Chairman, after three years of declining farm net income, an alarming number of U.S. farmers and ranchers are experiencing serious negative cash flow problems. This raises obvious questions about the ability of some farmers to maintain productive operations. Since 1979, overall prices received by farmers are up by 4.5 percent. Over the same three year period, prices paid by farmers are up about

22 percent. In each of the past two years, the nominal gain in the price of agricultural assets has been less than the general rate of inflation, resulting in a decline in the real wealth position of agriculture. In 1981 alone, the purchasing power of farm assets decreased almost $12 billion. This drop was only about 1 percent but it stands in marked contrast to the mid 1970's when net operating returns were modest, but capital appreciation was large in both nominal and real terms.

1982 offers perhaps a poorer income prospect than 1980 or 1981. This could make 1982 the third consecutive year of decreasing purchasing power of farm real assets. The last such period was 1931-33.

As this gloomy projection is realized in the agricultural sector, the economic health of the individual farmer will depend in great part on his level of indebtedness and the degree to which credit is available to finance his operation. Farm debt has nearly doubled in the past five years. The farm sectors debt servicing costs have grown even more sharply as farmers finance debt in the open market where rates are high, and have rolled over old debt at higher current rates of financing. Interest costs today make up about 13 percent of farmers total production costs, compared with about 7½ percent 10 years ago.

In 1981, total interest costs on farm real estate and non-real estate debt was about $19 billion. When compared to an estimated $29 billion net farm income in 1981 with an even lower projected income in 1982, the severity of the problem is clearly illustrated.

Total outstanding farm debt is expected to pass $200 billion sometime during this year with a debt/asset ratio of 17.1 percent as a total U.S. average. However, real estate assets make up over 75 percent of total farm assets and with appreciation of farmland values tapering off and actually showing decline in some areas that ratio could change rapidly this year.

Of the $200 billion farm debt figure, the Farm Credit System holds about 32 percent, commercial banks about 24 percent, the Farmers Home Administration about 11 percent and the remaining 33 percent is held by individuals and others, including insurance companies which hold about 14 percent of the outstanding real estate debt.

As is always the case when overviewing agriculture, some geographical areas have fared better than others. Currently the severest credit conditions seem to be centered in the high plains of Texas and in the southern parts of Georgia and Mississippi. Parts of Nebraska and Michigan also seem to be suffering disproportionately. It is from these areas that recent rumors of unusually high forclosure rates have sprung, but while the aformentioned lending institutions admit many farmers have very serious cash flow problems, they deny that mass forclosures are in the offing.

At recent meeting of officials of the FmHA, the FCA and the commercial bankers, it was agreed that every effort and resource would be directed toward helping farmers weather this period. They stressed that "forbearance" policies would be prevalent with refinancing, restructuring, reamortizing and deferal of payments all being considered on a case-by-case basis.

In spite of this assurance by the lending institutions, it is obvious that credit in the agricultural production sector is at a critical stage and we ask that Budget Committee considerations in 1982 keep agricultural needs in perspective.

Thank you for the opportunity to express my organizations views.

Sincerely,

Glen Hofer

Glen D. Hofer
Vice President

EXHIBIT A

LAW OFFICES
KOMINERS, FORT, SCHLEFER & BOYER
1776 F STREET, NORTHWEST
WASHINGTON, D.C. 20006

ODELL KOMINERS
JOHN CUNNINGHAM
MARK P. SCHLEFER
J. ALTON BOYER
T. S. L. PERLMAN
HARRISON D. HUTSON
MICHAEL JOSEPH
LEONARD EGAN
MARCUS B. SLATER, JR.
EUGENE F. MILLER
ALICE N. GRAN
STEPHEN T. OWEN
WILLIAM H. FORT
THOMAS L. MILLS

VICKI J. SHTEIR
TIMOTHY D. TRUSHEL
WILLIAM T. K. DOLAN

TELEPHONE (202) 467-5900
CABLE ADDRESS "MARLAW"

ADAM YARMOLINSKY
OF COUNSEL

J. FRANKLIN FORT
COUNSEL

March 25, 1981

MEMORANDUM RE: BASIC JUSTIFICATION FOR TITLE XI OF THE MERCHANT MARINE ACT, 1936.

The guarantee program of Title XI of the Merchant Marine Act, 1936, as amended, should be maintained and expanded as necessary to meet the requirements of the U.S.-flag merchant marine in foreign and domestic commerce, for the following reasons:

1. The program, under which the United States guarantees obligations assumed in financing new commercial vessel construction by private operators, efficiently and effectively attracts private capital to the marine industry without causing any distortion in world-wide or domestic credit markets. Title XI is a relatively small program in the context of overall federal government direct loan and credit guarantee programs, much less the federal budget itself. As of September 30, 1980, Title XI contracts and commitments in force totalled $7.2 billion, while the total of outstanding credit guarantees and loan insurance by U.S. government agencies and government corporations was $410 billion, and direct government loans totalled $165 billion.

In worldwide shipbuilding markets, the U.S. share of commercial ship construction is very small (4% of delivered tonnage in 1978), and virtually no ship construction in the U.S. is done for foreign interests. In foreign shipbuilding centers, such as Japan and Western and Eastern Europe, lower construction costs and much lower interest rates (usually subsidized), as low as 4.1% in Japan for Japanese-flag vessels, and 8.75% (under OECD guidelines) for vessels built for export, attract most of the world's business. In domestic markets, Title XI rates are generally comparable to Aaa utility bond interest rates, and are usually higher than long-term (20-year) government bond rates. Given the small share of the capital markets absorbed by Title XI, and the absence of any discernible resulting distortion in interest rates conceivably attributable to Title XI, it is unrealistic to argue that any such distortion occurs.

2. The Title XI program has been self-sustaining since its inception in 1938. The Federal Ship Financing Fund, into which are paid the proceeds of annual premiums on guaranteed obligations and application and investigation fees, enables the Maritime Administration to pay all salaries and administrative expenses of the program without any contribution whatever from the U.S. Treasury, and the Fund currently has a net reserve (as of September 30, 1980) of more than $190 million. The Fund has also absorbed all defaults that have occurred, again without any cost to the taxpayers. In fact, the default rate of Title XI has been extraordinarily low, only seven-tenths of one

percent (net losses of only $62.9 million out of $8.8 billion of guarantees from 1938 to date). Of that total, the failure of Pacific Far East Line several years ago cost the Fund $50 million, the only default to date to result in major unrecovered cost. The more recent failure of States Steamship Company has resulted in no losses, and the apparent weak financial condition of Seatrain Lines threatens no loss (except possibly on one barge), in both cases because the vessels involved are profitably employed and hence are readily marketable.

3. Absent Title XI virtually no vessels for use in the foreign commerce of the United States could be privately financed. The long term of the obligations (up to 25 years) renders financing by large commercial banks and other traditional credit institutions impracticable. The primary investors in Title XI bonds, major pension funds, are for security reasons restricted to government or government-guaranteed obligations. Moreover, since the primary security for the obligations is the vessel itself, the Maritime Administration uniquely has the ability to sell vessels at a reasonable price in the event of default. A private lender could not, as the Maritime Administration can, hold a vesself off the market, in the reserve fleet, pending a change in market conditions which would enable sale of the vessel at a profit. Thus Title XI is essential to future commercial shipbuilding for the U.S.-flag merchant fleet in foreign commerce. Absent Title XI, our economy simply lacks the institutions to finance major vessel construction projects.

4. Title XI has effectively promoted the construction of more than 2,700 vessels to date, not including shipboard lighters, and has thereby directly benefited national security by providing a U.S.-flag reserve fleet to support military operations in time of war or national emergency. Title XI has also thereby supported a large domestic shipbuilding base. Approximately 40% of the 170,000 shipyard workers currently employed work on commercial vessels financed by Title XI. Even an expanded naval shipbuilding program would not absorb a greater share of shipyard labor for two or more years. Moreover, recent studies have shown that every dollar spent on ship construction generates from $4.70 to $6.60 in the economy generally, and every million dollars spent employs 41 new workers in the overall economy.*/ Absent Title XI, reliance would have to shift to foreign-flag carriers and foreign shipbuilding centers which might prove unreliable in the event of national emergency.

Hence Title XI is a proven successful, low-risk and efficient mechanism to promote the U.S.-flag merchant marine and the domestic shipbuilding base at no cost to the U.S. Treasury, and with no distortion in the credit markets. In order to continue its record of success, the Title XI program should be permitted to develop and expand as the reasonable requirements of the U.S. marine industry require, by elimination of annual non-statutory ceilings on the amount of commitments that can be extended, and periodic prudent increases in the statutory ceiling on commitments (currently $9 billion for non-fishing vessels).

---

*/ See also Data Resources, Inc., "The Economic Impact of the U. S. Shipbuilding and Ship Operating Industries," October 1979. This two year study corroborates the favorable effects on the general economy. Additionally, the DRI study measures very significant improvements in net investment and trade balance. Perhaps most important in the present environment, DRI concludes that the current direct maritime subsidy program has the effect of decreasing the federal deficit because of the private capital formation and employment that results. With Title XI, this leverage over the federal deficit is gained with no front end expenditures by the government at all.

The accompanying memorandum explains in detail each of the foregoing points, and related matters. In addition, that memorandum furnishes a summary of the legislative history of Title XI, demonstrating the lengthy evolutionary process from 1938 to 1972 which finally resulted in the present effective and efficient program. In fact, the two major periods of legislative development occurred under the Eisenhower and Nixon Republican administrations, in the years 1953-1956 and in 1972, respectively. This history is also helpful to an understanding of how the program actually works.

TABLE OF CONTENTS FOR MEMORANDUM

Page

Introduction 1

No Distorting Effect on Capital Markets 3

Impact on Shipbuilding and the Economy 6

Current Status of the Title XI Program 8

Future of Title XI 10

Administration of the Program 12

Need For and History of Title XI 15

  A. Need for Title XI 15

  B. Origin of Title XI -- 1938-1953 16

  C. Revision of Title XI -- 1953-1970 18

  D. Most Recent Title XI Legislation 22

Conclusion 25

LAW OFFICES
KOMINERS, FORT, SCHLEFER & BOYER
1776 F STREET, NORTHWEST
WASHINGTON, D.C. 20006

ODELL KOMINERS
JOHN CUNNINGHAM
MARK P. SCHLEFER
J. ALTON BOYER
T. S. L. PERLMAN
HARRISON D. HUTSON
MICHAEL JOSEPH
LEONARD EGAN
MARCUS B. SLATER, JR.
EUGENE P. MILLER
ALICE M. GRAN
STEPHEN T. OWEN
WILLIAM H. FORT
THOMAS L. MILLS

VICKI J. SHTEIR
TIMOTHY D. TRUSHEL
WILLIAM T. K. DOLAN

TELEPHONE (202) 467-5900
CABLE ADDRESS "MARLAW"

ADAM YARMOLINSKY
OF COUNSEL

J. FRANKLIN FORT
COUNSEL

March 25, 1981

MEMORANDUM

BASIC JUSTIFICATION FOR THE GUARANTEE PROGRAM OF TITLE XI OF THE MERCHANT MARINE ACT, 1936, AS AMENDED

The guarantee program established by Title XI of the Merchant Marine Act, 1936, as amended, 46 U.S.C. §§ 1271 ff. has been recognized in Congress as "the most successful promotional program administered by the Maritime Administration" of the U.S. Department of Commerce.[1/] Under the Title XI program, the United States, represented by the Secretary of Commerce, guarantees the obligations of qualified shipowners who obtain private financing for the construction, in U.S. shipyards, of vessels and barges for employment, under U.S. registry, in the foreign and domestic commerce of the United States. The program has promoted the construction in U.S. shipyards of more than 2,700 vessels and more than 3,000 lighters (barges carried aboard large cargo vessels) without any cost whatever to the taxpayers.

The Federal Ship Financing Fund, which is funded by the proceeds of Title XI application and investigation fees, and annual premiums on guaranteed obligations, enables the Mari-

---

[1/] Report of the Hon. Thomas N. Downing, Chairman, Subcomm. on Merchant Marine of the House Comm. on Merchant Marine and Fisheries on the Oversight Hearings With Respect to the U.S.-Flag Merchant Marine. H.R. Doc. No. 94-M, 94th Cong., 2d Sess. 139 (1977) (hereinafter "Downing Report").

time Administration to pay all salaries and expenses of administering the program, without any contribution by the Treasury.[2/] The Fund has also absorbed the few defaults that have occurred, again without cost to the Treasury, and the Fund currently has a net balance of nearly $200 million. From 1938 to date, the program has guaranteed approximately $8.8 billion of obligations, defaults have resulted in a net loss of only $62.9 million (seven-tenths of 1%), all of which was paid out of the privately generated Fund.

Not only does the Title XI program promote the construction of modern, technologically advanced vessels for the U.S. foreign and domestic waterborne commerce, and provide for the employment of tens of thousands of American merchant seamen and shipyard employees, but it also preserves a substantial U.S. shipbuilding base essential to national defense; furnishes a ready reserve fleet for support of military operations in time of war or national emergency; and provides the means for economical shipment of commodities such as petroleum, coal, and grain in the domestic coastwise and Great Lakes trades, and the inland waterways.

Promotion of shipbuilding in itself generates a major "ripple" effect on the economy as a whole. Since shipbuilding activity requires purchase of material and equipment from nearly every major industrial group, it has been estimated that every dollar spent on U.S. shipbuilding generates $4.70 in the economy as a

---

[2/] Downing Report, supra, note 1, at 115-116; Hearings on Title XI Oversight before the Subcomm. on Merchant Marine of the House Comm. on Merchant Marine and Fisheries, 95th Cong. 2d Sess. 377 (1978) (Statement of Roy Yowell).

whole, in the form of incomes to businesses, wages and salaries, and indirect business taxes.[3/] In addition, it promotes a favorable balance of payments by minimizing the flow of U.S. capital to foreign shipyards and foreign-flag carriers; and facilitates exports of coal and grain.

Yet its success in attracting private capital to U.S.-flag vessel construction projects at no cost to the government has been accomplished without any distorting effect on capital markets either domestically or abroad.

No Distorting Effect on Capital Markets

Although Title XI provides an effective incentive for investment of private capital in U.S.-flag ships, there is no basis for the conclusion that Title XI in any sense distorts the credit markets either worldwide or domestically.

It should be emphasized that Title XI guarantees represent a tiny fraction of the total credit guarantee and insurance activity of the U.S. government. The U.S. Treasury Department reported that as of September 30, 1980, agencies and U.S. government corporations had outstanding guarantees and loan insur-

---

[3/] H. Chung, Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978 p. 3-14 (U.S. Dep't of Commerce 1981). See also Data Resources, Inc., "The Economic Impact of the U. S. Shipbuilding and Ship Operating Industries," October 1979. This two year study corroborates the favorable effects on the general economy. Additionally, the DRI study measures very significant improvements in net investment and trade balance. Perhaps most important in the present environment, DRI concludes that the current direct maritime subsidy program has the effect of decreasing the federal deficit because of the private capital formation and employment that results. With Title XI, this leverage over the federal deficit is gained with no front end expenditures by the government at all.

ance in a total amount in excess of $410 billion,[4/] of which Title XI represented only $5.9 billion (1.5%).[5/] Hence, even in the context of U.S. Government loan and guarantee programs, Title XI is a very small program.

Second, viewed in the context of the worldwide credit market, Title XI has no conceivable impact. The United States shipbuilding industry represents only a small share of total commercial vessel construction. In 1978, for example, U.S. shipyards delivered only 15 of the 965 deepdraft vessels delivered worldwide (4% of the total tonnage). Japan alone delivered 386 vessels (approximately one-third of the total tonnage). The United Kingdom, Spain and Sweden delivered vessels of equal or greater tonnage to that delivered in the United States.[6/] The primary reason for this imbalance is the favorable financing and credit terms available in such other countries. In Japan, for example, LNG and liner vessels can be built for domestic-flag companies at a net average subsidized interest rate of 4.1%; tramp vessels at 4.6%;

[4/] Representing an increase from $289.9 billion as of September 30, 1979. Treasury Bulletin pp. 142-146 (U.S. Treasury Department December 1979).

[5/] By comparison, the Farmer's Home Administration administered guarantee programs guaranteeing or insuring $44 billion of credit; Education Department student loan guarantees totalled $8.3 billion; the Federal Housing Administration guaranteed $121 billion of obligations and other HUD guarantees totalled in excess of $100 billion; the Veterans Administration administered loan guarantees in excess of $44 billion; and the Rural Electrification Administration administered nearly $11 billion of guarantees. Treasury Bulletin pp. 130-136 (U.S. Treasury Department December 1980). Direct U.S. government loans totalled more than $165 billion at the same time. Id.

[6/] 1979 Annual Report of the Maritime Administration, p. 12.

and tankers at 5.1%. Repayment is over a 11-year period, with no principal payment required on 75% of the loan during the first three years. Similarly generous benefits are available in other shipbuilding nations, and subject to Organization for Economic Development guidelines, only slightly less generous benefits are available for ships constructed for export. (OECD guidelines specify a minimum interest rate of 8.75% for ships built for export.) Recently quoted Title XI interest rates of around 14% (higher rates prevailed within the last year) are extremely unfavorable by comparison.

Second, in the domestic credit markets, Title XI is, as noted, small in comparison to even other Government guarantee programs. It is unrealistic to allege that significant amounts of capital flow to Title XI financed projects that would go to other investments. While Title XI mortgages are viewed as high quality obligations in the financial market, the spread in interest rates between Title XI bonds and other types of long-term obligations do not indicate any distortion attributable to Title XI. Generally, interest rates on Title XI bonds have approximated prevailing rates on Aaa utility bonds or Aaa long-term corporate bonds, and are higher than average rates for long-term Government bonds. Moreover, the range of interests potentially affected by diversion of capital to Title XI projects is so vast, given the size of the economy as a whole, the effect on any given sector would in any case be minimal.

Finally, it must be remembered that Title XI is an incentive program intended from the outset to attract private capital to a defense support sector of U.S. industry. The ultimate beneficiary of the program is the United States itself. Without Title XI incentives, the alternatives would be diminution of the U.S.-flag merchant marine and shipbuilding sectors; or direct government investment in ship construction by way of additional subsidies or direct Government loans; or construction for the Government's account. Title XI is the most efficient promotional device available, since it has been effective, and has cost the U.S. taxpayers nothing whatever.

Impact on Shipbuilding and the Economy

The Title XI program not only promotes development and maintenance of a diverse U.S.-flag merchant marine, but it also assures the continued existence of a larger domestic shipbuilding base. While the U.S. Navy is the largest single customer of U.S. shipyards, the Shipbuilders Council of America estimates that about 35% of the workers employed in U.S. shipyards work on construction of new military vessels, while perhaps 33% work on commercial deep draft vessels, and another 7-10% work on other commercial marine construction. The total shipyard and ship repair work force currently is about 170,000 workers.[7/]

Even assuming that a substantially increased naval shipbuilding program will in future years absorb a greater portion of shipyard capacity, design and engineering work on new military ships will delay actual construction for several years; and military

---

7/ U.S. Dep't of Labor, Bureau of Labor Statistics, Computer Printout "Shipbuilding and Repairing -- All Employees."

shipbuilding, like commercial shipbuilding tends to be cyclical over the long term.

Some of the major shipyards, such as Bath Iron Works in Bath, Maine; Quincy Shipbuilding Division of General Dynamics Corporation in Quincy, Massachusetts; Newport News Shipbuilding & Drydock Co. in Newport News, Virginia; Avondale Shipyards, Inc., in New Orleans, Louisiana; and Ingalls Shipbuilding Division of Litton Industries in Pascagoula, Mississippi, are said to be the largest employers in their respective states. In addition, more than two hundred other companies of varying sizes are engaged in ship construction and repair (exclusive of companies constructing small boats and pleasure craft), and are located in virtually every region of the country. Overall, more than 40% of the work in these construction and repair yards is generated by U.S. domestic ship operators.8/

Since shipbuilding requires purchase of materials and supplies from virtually every sector of the economy, it has been estimated that $1 spent on new vessel construction generates an average of $4.70 of industrial output in the overall economy.9/ In addition, each million dollars expended on shipbuilding results in the employment of an additional 41 workers in the overall economy.10/

8/ H. Chung, Economic Impact of Maritime Industries on the U.S. Economy -- 1971-1978, p. 3-3 (U.S. Dep't of Commerce 1981).

9/ *Id*. p. 3-7. If the household sector is added, the figure becomes $6.67 of impact for every dollar expended.

10/ *Id*. p. 3-8.

Absent Title XI incentives, however, it is doubtful that a significant portion of commercial vessel construction for foreign commerce would continue in U.S. shipyards. As noted, foreign shipbuilding centers can produce vessels at substantially less cost, and offer extremely favorable subsidized financing terms for vessels. Although the major foreign shipbuilding centers are members of the Organization for Economic Cooperation and Development, which imposes restrictions on the terms that can be offered for ship construction for export (currently a minimum 8.75% interest rate), those terms are in any event more favorable than those prevailing in the United States (the current Title XI interest rate is around 14% on a 25-year loan).

Hence the lower cost and more favorable terms guarantee that any vessel that could be built abroad will be. U.S. shipyards build virtually no vessels for foreign accounts.

Current Status of the Title XI Program

As of September 30, 1979, the last date as to which officially published data is available, Title XI guarantees or commitments were in effect with respect to 2,516 vessels and 1,882 lighters, guaranteeing for total obligations of $6,376,946,886. At that time, applications were pending with respect to an additional 330 vessels and 201 lighters, requesting guarantees on slightly more than $3 billion of obligations. 1979 Annual Report of the Maritime Administration, p. 14. Preliminary data available for FY 1980 indicates that as of September 30, 1980, contracts or commitments in force covered $7,214,984,347 of obligations with respect to 2,782 vessels and 2,118 lighters, with applications pending as to 988 vessels and 409 lighters in the total amount of approximately $4.2 billion.

Approximately two-thirds of the amounts guaranteed by current contracts relates to so-called "deepdraft" vessels: 75 tankers; 153 dry cargo vessels; 16 LNG carriers; and 18 bulk carriers or OBO's. The remaining obligations cover a variety of vessels including drilling rigs, tugs, barges, drill service vessels, etc.

The Federal Ship Financing Fund (funded entirely by the users of the financing) has, all the while, grown significantly. Comprising slightly more than $25 million in 1970, the fund currently accumulates that much or more every year, after payment of salaries and other administrative expenses. As of September 30, 1980, the Fund had a balance of $190,495,651. The net growth of the Fund was $43.9 million in 1978 (1978 Annual Report, p. 10), $25.6 million in 1979 (1979 Annual Report, p. 10) and $42.2 million for FY 1980 (estimated). These amounts are net of payments of $50 million to honor obligations following the failure of Pacific Far East Line. The recent failure of States Steamship Company, and reported serious financial difficulties of Seatrain Lines do not appear to threaten any loss whatever to the Fund, since all vessels involved with respect to both companies are capable of profitable employment and are readily marketable.

Title XI, however, is currently operating at less than its full potential. Although the current statutory ceiling available for guarantees for non-fishing vessels is $9 billion, and Congress has never imposed annual ceilings, the Office of Management and

Budget has imposed ceilings of $900 million of new commitments through September 30, 1981, and $1,050,000,000 for FY 1982. These amounts appear to be substantially less than could be extended on credit-worthy projects subject of pending applications. A total of $1.1 billion of new commitments were issued during FY 1980, and but for the non-statutory ceiling at least $1.3 billion could be issued in FY 1981.[11/] The excess will likely be deferred until FY 1982, further reducing the opportunity to process to completion new applications for that year, and creating grave difficulties for applicants bound by firm construction contracts.

Future of Title XI

Occasionally, opinion has been expressed that in time, Title XI might become totally self-sustaining in the sense of not requiring further increases in the authority of the Secretary of Commerce to insure obligations.[12/] There are several reasons why this prospect is not imminent.

First, vessel construction costs continue to escalate dramatically. This is the result not only of the predictable ravages of inflation, but also is due to continuing technological improvement of vessel capabilities. Vessels which cost $5-$10 million in the early 1960's cannot be replaced for less than

---

[11/] Decommitment and amortization of prior guarantees for 1979 and 1980 were $250 million and $388 million respectively.

[12/] Hearings before the Subcomm. on Merchant Marine of the House Comm. on Merchant Marine and Fisheries on Title XI Guarantee Program, 94th Cong. 2d Sess. 249-250 (1976) (Statement of Robert J. Blackwell).

$50-$100 million today, partly due to inflation, but also due to the fact that the ships of 20 years ago were significantly less complex. Vessels that are not technologically current cannot compete effectively.

Second, the current liner cargo fleet was largely constructed in the 1960's. Hence the vast majority of the liner fleet operating in foreign commerce will pass a normal 25-year useful service life in the period 1985-1995. Substantial commitments of Title XI will be mandatory unless the U.S.-flag liner fleet in foreign commerce is to be allowed to disappear. While the existing liner fleet was substantially constructed when the statutory Title XI ceiling was $1 billion dollars, that amount is obviously inadequate for the reasons cited above, so "recycling" of the guarantees alone will not be sufficient.

Further, despite the success of Title XI to date in promoting construction, there is not a single commentator who can be heard to argue that the U.S. Merchant Marine is of an adequate size and complexion. Replacement of existing vessels as they become overage should be matched with a complementary construction of additional vessels.

Hence, Title XI should be allowed to develop as the needs of the Merchant Marine require, by removal of non-statutory annual ceilings, and as necessary, by periodic prudent increases in authority to guarantee obligations. The proven success of Title XI in promoting U.S.-flag vessel construction in U.S. shipyards, at no cost whatever to the taxpayers, demonstrates the wisdom and effectiveness of attracting private capital to the marine industry. In the absence of continuing support for the Title XI program the past successes will likely, in retrospect, have proven to be only a temporary stop-gap prior to the substantial deterioration of a U.S.-flag Merchant Marine.

Administration of the Program

One predominant reason for the low default rate under Title XI (less than seven-tenths of 1% to date) is that the Title XI program has been prudently administered.

> The most important test of eligibility for Title XI assistance is that the applicant must show the economic soundness of the proposed project. This means that the applicant must submit substantial market and operating cost information from which we may reasonably conclude that the project is economically sound, that is, successful.
>
> * * *
>
> In this regard, it must be found that (1) the project is economically sound, (2) the applicant has the financial resources to carry out the project, (3) the applicant has the necessary operating ability, (4) the actual cost of the vessel must be determined, and (5) the design of the vessel must be approved.13/

Not only are the financial resources of the applicant and the soundness of the proposed venture carefully analyzed, but the design of the vessel and breakdown of actual cost are painstakingly investigated. The vessel must be certified by the U.S. Coast Guard, and meet the requirements of a Class A-1 rating of the American Bureau of Shipping, or equivalent standards

---

13/ Hearings, *supra*, note 12, at 234-236 (Testimony of Robert J. Blackwell). See generally, 46 U.S.C. § 1274; 46 C.F.R. §§ 298.10 ff.

established by the Secretary. The proposed vessel operator must meet stringent requirements for operating experience and ability.

In addition, the operator is required to establish certain restricted funds out of its earnings, to enable it to remain solvent in the event the vessel's operations are curtailed for any reason.[14/] During 1975, for example, no less than 13 tankers built pursuant to Title XI guarantees were unable to obtain employment of any kind, a situation that in some cases persisted for approximately one year, yet not one default occurred. More than $50 million in obligations were there involved.[15/]

The operator must also maintain the vessel to the satisfaction of the Maritime Administration. It is the vessel itself, not the Federal Ship Financing Fund, which provides the primary security in the event of default. The rapid escalation in shipbuilding costs over the past two decades makes the vessel a valuable asset. Many of the vessels subject of Title XI guarantees could readily be sold at a substantial profit, in excess of the funds paid out to honor the guarantee.[16/] Even in those instances where the vessels could not be sold immediately after a default, the U.S. reserve fleet, a naval auxiliary in time of emergency, would be augmented until market conditions improved

---

[14/] Hearings, supra, note 2, at 395 (Statement of Roy Yowell).

[15/] Report of Hon. Leonor K. Sullivan and Hon. Phillip Ruppe, Subcomm. on Merchant Marine of the House Comm. on Merchant Marine and Fisheries on the Oversight Hearings with Respect to U.S.-flag Merchant Marine 111-112 (1977)(hereinafter "Sullivan Report").

[16/] Downing Report, supra, note 1, at 134-5.

to the point at which the vessel could be sold at a reasonable price.[17/]

In this connection, it is emphasized that the Title XI guarantees cover a variety of vessel types, and are not concentrated in one sector of the industry. While dry cargo vessels were the predominant type of vessels built with Title XI aid in the 1960's, the 1970's saw a relative decline in liner construction, but a substantial expansion in construction of tankers; LNG vessels; ocean tugs and barges; river tugs and barges; bulk carriers and OBO's; oil drilling vessels; and drilling rig supply vessels, among others. Indeed, of Title XI contracts in force as of September 31, 1979, the principal amounts guaranteed were nearly equally divided among tankers ($1.2 billion); cargo vessels ($1.2 billion); LNG's ($1.3 billion); and tugs, barges, and drilling service vessels ($1.3 billion). Lesser amounts of guarantees were involved for other types of vessels. 1979 Annual Report of the Maritime Administration at 14.

Hence while Congress has periodically reviewed the question of potential exposure, as the ceiling on authority to guarantee obligations has been increased, the risks have at all times been viewed as acceptable, in large part due to the careful management of the program.[18/]

[17/] Id.

[18/] Downing Report, supra, note 1, at 135. See also S. Rep. No. 1119, 90th Cong., 2d Sess. 3 (1968) (the Maritime Administration "has acted prudently and wisely in granting insurance"); S. Rep. No. 94-96, 94th Cong., 1st Sess. 15 (1975). It goes without saying, of course, that if Title XI guarantees were extended only under circumstances that would satisfy a major commercial bank as to degree of risk, there would be no need for Title XI.

Need for and History of Title XI

A. Need for Title XI

In the absence of Title XI financing, vessel operators would have considerable difficulty obtaining financing on economic terms. The financial institutions which extend credit for most commercial ventures have not been available to vessel construction projects. In particular, given the relative length of the loan term (up to twenty-five years), large commercial banks have not been involved.

Experience has established that the primary purchasers of Title XI bonds have been, in recent years, large pension funds, which for security purposes must invest in government securities or government guaranteed obligations.

Moreover, since the primary security for the obligations is the vessel itself, the Maritime Administration is uniquely positioned to get the best price for the vessel in the event of a default. If market conditions are unfavorable, it can hold the vessel in the reserve fleet until conditions improve, a luxury commercial lenders do not have.

Hence absent Title XI, financing for a substantial portion of the U.S.-flag merchant marine simply would not be available.

In this connection, it will be useful to examine the origins and subsequent legislative history of Title XI for three reasons. First, this history explains how the present Title XI program developed, and demonstrates that the program did not function effectively or efficiently until cast into substantially its present form. Second, it shows the commitment of successive Democratic and Republican administrations to make the program effective to solve the persistant problems relating to financing of vessel construction. Third, it illustrates the types of problems Title XI is intended to, and does alleviate.

B. Origin of Title XI -- 1938-1953

Title XI was added to the Merchant Marine Act, 1936, by amendments passed in 1938. Act of June 23, 1938, c. 600 § 46, 52 Stat. 969. The amendment was the result of an investigation by Congress that disclosed that while the 1936 Act had provided incentive for improvement of the U.S. merchant marine in foreign commerce, insufficient attention had been paid to the coastwise, Great Lakes and inland waterways traffic, which was in a shocking state of obsolescence.[19/]

Rather than direct subsidy, or construction of vessels for the Government's account, or direct Government loan, it was believed that a program of mortgage insurance "is in line with the President's philosophy of inducing private capital to become interested" in financing vessel construction, and "would not in any way interfere with the Administration's desire to reach a balanced budget at any early date."[20/] Moreover, the "proposed

---

[19/] Hearings Before the House Comm. on Merchant Marine and Fisheries on H.R. 8532, 75th Cong., 2d-3d Sess. 150-153 (1937) (Statement of Congressman O'Leary); H.R. Rep. No. 2168, 75th Cong., 3d Sess. 13-15 (1938).

[20/] Hearings, *supra*, note 13 at 154.

premium on the face value of the mortgage would immediately build up a fund so that this activity would result in no cost to the Government."[21/] Congress believed that the new ships constructed pursuant to this program would provide training for new personnel to man vessels in both the domestic and foreign trades; increase productivity and the labor base in domestic shipyards; stimulate industry in many sectors of the economy; reduce unemployment; and benefit national defense.[22/]

Despite these optimistic forecasts, however, the program was not successful during its first 15 years, insuring only 12 loans or mortgages in the total principal amount of less than $6 million.[23/] Among the reasons for its lack of success were the fact that most vessels in foreign commerce were not covered; the insurance was not available for financing while the vessels were under construction; upon default the mortgagee was required to foreclose on the vessel before making a claim against the insurance; and the insurance proceeds were paid not in cash but in debentures, paying not more than 3% interest, and maturing 3 years after the maturity date of the loan or mortgage.

21/ H.R. Rep. No. 2168, 75th Cong., 3d Sess. 15 (1937).

22/ Id. at 15-16.

23/ Hearings before a Subcomm. of the Senate Comm. on Interstate and Foreign Commerce on S. 2408 and S.2409, 83rd Cong., 1st Sess. 12 (1953) (Statement of Robert B. Murray, Jr.).

C. Revision of Title XI -- 1953-1970

During World War II, the lack of an adequate merchant fleet and the failure of the Allied powers to make vessels available to the United States, required a massive Government-financed shipbuilding program. The lessons of World War II, coupled with the failure of the original Title XI legislation to promote significant shipbuilding, made it an urgent priority of the new Eisenhower administration to cure the deficiencies in the Title XI program.[24] Secretary of Commerce Weeks stated:

> As long as we are in this business of trying to promote ship construction and operation, this is one way of getting private capital into the business, encouraging private capital to come into the business to the end that on the law of averages the Government certainly would not have to put up the money in the first instance and might never have to put up the money except on the basis of insurance risk.[25]

Making the program effective proved difficult to accomplish. A majcr restructuring was done in 1953. Act of August 15, 1953, c. 513, Pub. L. 288, 67 Stat. 626. That legislation extended Title XI coverage to vessels for use in foreign commerce; provided that upon default the Secretary of Commerce could accept assignment of the mortgage and cause foreclosure (instead of requiring the mortgagee to foreclose); and provided that upon default the lender should be paid in cash rather than debentures. There was also added a provision for insurance of short-term construction period loans as well as long-term mortgages. The 1953 Act, however, had major weaknesses. Primarily, the Secretary was authorized to insure mortgages only up to 90% of 75% of the cost of the vessels. The purchaser was required to have a 25% equity interest in the vessels, but it was felt, in addition, that the lender should be at risk to the extent of 10% of the remaining 75% of cost.[26] In addition, the Secretary had to determine that the mortgage rate was substantially less than the going rate for uninsured mortgages.

---

[24] S. Rep. No. 821, 83rd Cong., 1st Sess. (1953); H.R. Rep. No. 1042, 83rd Cong., 1st Sess. (1953); Hearings, note 23 supra, 27-28 (1953) (Statement of Hon. Sinclair Weeks). Mr. Weeks, the Secretary of Commerce, called attention to the "urgency of the situation." Senator Magnuson recalled the "sad experience" of World War II where "although it was the intention of the rest of the free world to give us their tonnage, as a practical matter it did not work out that way." Id. at 31. Although a large number of vessels were built in World War II, the emergency emphasis on quantity over quality rendered those vessels obsolete almost immediately.

[25] Hearings, note 23, supra, 33.

Because the revised Title XI failed to stimulate private financing, further amendments were promulgated in 1954. Act of September 3, 1954, c. 1265, Pub. L. 781, 68 Stat. 1269. Certain vessels were now insurable up to 90% of 87-1/2 percent of the vessel cost; and in the case of "special purpose" vessels certified by the Secretary of Defense to be required for national defense, 100% of the cost was insurable. Insurance could cover

---

26/ This restriction was based on a suggestion of the Comptroller General that if the lender were at risk on 10% of the mortgage principal, the Government would derive the benefit of the private lender's credit investigation procedures. This proved unrealistic. Many lenders refused to accept any risk at all. Others agreed to finance vessels only if the owner deposited cash collateral equal to the uninsured 10% of the Mortgage, in effect substantially increasing the Owner's downpayment See S. Rep. No. 821, 83rd Cong., 1st Sess. (1953); S. Rep. No. 2632, 84th Cong., 2d Sess. (1956).

mortgages bearing up to a 5% interest rate, or 6% upon findings by the Secretary that such higher rate was necessary.[27]

In approving the 1954 amendments, the House Committee stated:

> By reason of the inherent uncertainties in the business of operating ships, private capital has been reluctant to undertake to any appreciable extent the risks of lending money secured by ships mortgages. Such private financing is desirable not only because it will take the Government out of the business of lending money secured by ship mortgages but also because it will tend to enlist the aid of the banking business in problems of the American merchant marine.[28]

The 1954 amendments were not sufficient, however, and only two major loans were insured thereunder, one for a "special purpose" vessel as to which 100% financing was available, the other in a situation in which the owner was willing and able to put up cash collateral to cover the uninsured 10% of the loan. Consequently, by further amendment in 1956, the 90% limitation was dropped, and the Secretary could now insure mortgages fully up to 75% or 87-1/2% of vessel cost, as the case may be. (Vessels built with construction subsidy may be financed under Title XI only up to 75% of cost.) Act of August 7, 1956, C. 1026, Pub. L. 1017, 70 Stat. 1087; See S. Rep. No. 2632, 84th Cong., 2d Sess. (1956).

In addition, in 1958, Congress authorized the Secretary of Commerce to borrow funds from the Secretary of the Treasury to pay in the event of default on an insured obligation if the

---

[27] The 1954 Amendments also gave the Secretary cumulative authority to provide insurance for up to $1 billion of obligations.

[28] H.R. Rep. No. 2450, 82rd Cong., 2d Sess. (1954).

Federal Ship Mortgage Insurance Fund[29] had insufficient funds, subject to repayment when sufficient funds were accumulated. This change was designed to assure lenders that upon default, the Government guarantee would be promptly honored. Act of July 15, 1958, Pub. L. 85-520, 72 Stat. 358.

The cumulative effect of the various amendments from 1953 to 1958 finally succeeded in stimulating the Title XI program into effective operation. By 1962, insurance contracts and commitments in force covered $458,847,432 of obligations, for 70 vessels, with applications pending for insurance respecting an additional 34 vessels. 1962 Annual Report of the Maritime Administration, U.S. Department of Commerce, pp. 5-6. By 1967, the amounts insured by contracts in force had increased to $562,096,000 on 113 vessels. 1967 Annual Report of the Maritime Administration, p. 21.[30] By the end of fiscal year 1970, the total insured was $919,418,003, covering 171 vessels and 360 barges.[31] 1970 An-

---

[29] Now known as the Federal Ship Financing Fund.

[30] Between 1958 and 1970 other changes were made to the program, including a provision to allow insurance to cover the obligations of bonds sold to the public, and permitting mortgages to be placed on existing vessels to finance the construction of new vessels (Act of July 31, 1959, Pub. L. 86-127, 73 Stat. 72); extending the maximum mortgage term from 20 to 25 years (Act of June 12, 1960, Pub. L. 86-518, 74 Stat. 216); and removal of the 6% ceiling on interest rates (Act of June 15, 1968, Pub. L. 90-341, 82 Stat. 180).

[31] The principal thrust of the Program's activity during the 1960's was wholesale replacement of the country's overage and obsolete liner fleet. Of the 171 vessels built or under construction with aid of Title XI insurance as of June 30,

[continued on following page]

nual Report of the Maritime Administration, pp. 21, 25 (1971). Since by the end of 1970 the $1 billion ceiling on the Maritime Administration's authority to insure mortgages was nearly reached, the Merchant Marine Act of 1970 increased the authority to $3 billion. Act of October 21, 1970, Pub. L. 91-469, § 30, 84 Stat. 1018.

D. Most Recent Title XI Legislation

A further major restructuring of Title XI occurred in 1972 under the Nixon Administration. Federal Ship Financing Act of 1972, Act of October 19, 1972, Pub. L. 92-507, 86 Stat. 909. The purpose of the legislation was "to expedite procedures, simplify paperwork, and better meet the current needs for investment capital necessary to revitalize the American Merchant Marine."[32/]

As the House Committee report stated:

> The existing Title XI program has been successful. . . . The moblization of private capital has never been more important than now, in the light of the building program contemplated by the Merchant Marine Act of 1970.
>
> Since the inception of the program, contracts or commitments have been entered into to finance 519 vessels and 820 lighters which represented shipyard contracts of approximately

---

31/ [continued from preceding page]

1970, 110 were freighters, and 11 were combination passenger/cargo vessels. 1970 Annual Report, p. 24. See also Hearings Before the Subcomm. on Merchant Marine of the House Comm. on Merchant Marine & Fisheries on Title XI Guarantee Program, 94th Cong., 2d Sess. 196-7 (1976) (Statement of Albert E. May).

32/ S. Rep. No. 92-1137, 92nd Cong., 2d Sess. 1 (1972); see also H.R. Rep. No. 92-68, 92d Cong., 1st Sess. (1971).

> $2.5 billion. Applications pending involve construction or reconstruction of approximately 88 vessels and 955 lighters with estimated mortgages of $507,000,000 and shipyard contracts of some $800,000,000. There have been defaults on only 8 vessels, most of which are now in service. The Federal Ship Mortgage Fund now has a favorable balance in excess of $30 million. Although these data demonstrate the substantial contribution of the Title XI financing program to the American Merchant Marine, passage of time has revealed deficiencies which should be corrected.[33]

Several significant changes were made to the structure of Title XI. It was now provided that instead of insuring a mortgage or loan, the United States would issue a direct guarantee of the obligations sold to purchasers, in order to reduce complexity and paperwork and to promote the development of a secondary market.[34] Second, all collateral security for the loan would run directly to the Secretary. This would avoid the cumbersome procedure, upon default, of assigning the mortgage to the Secretary, and would also simplify the transaction in the first instance.

Third, the 1972 act removed restrictions on refinancing which had previously required that the new interest rate must be lower than the original rate. Under the current standards, refinancing is permissible (even if the prior mortgage was not under Title XI) for a variety of purposes, including the construction, reconstruction or reconditioning of vessels; purchase of vessels from the Maritime Administration;[35] or repayment of construction-differential subsidy (e.g., to permit vessels originally intended for use in the foreign commerce to operate in the domestic coastwise trade). Refinancing of short-term obligations is specifically allowed, to permit operators to obtain short-term financing in time of excessively high long-term rates, and subsequently shift to a long-term loan when rates decline.

---

[33] H.R. Rep. No. 92-688, supra, note 32, at 2-3.

[34] S. Rep. No. 92-1137, supra, note 32, at 3.

[35] Generally, Title XI cannot be used to purchase existing vessels from private owners.

The 1972 legislation cast Title XI into substantially its present form, and represented the cumulative experience of the Government and industry over more than three decades as to the form of arrangements which would maximize the flow of private capital into private ship construction at least cost and expense to the Government. As the Senate Report on the 1972 Act noted:

> Close collaboration between industry, Government, and the financial community in developing legislation has been characteristic in this evolutionary process.[36]

At the present time Title XI guarantees may be obtained for passenger, cargo, and fishing vessels, tankers, towboats, dredges, barges, floating drydocks, oceanograph research or instructions vessels, off-shore drilling rigs, and pollution treatment, abatement or control vessels.

Subsequent to 1972, the only significant revisions have been an increase in the Secretary's cumulative authority to guarantee obligations. This authority was increased from the $3 billion authorized in 1970 to $5 billion in 1973;[37] to $7 billion in 1975;[38] and to $10 billion in 1978.[39]

---

[36] S. Rep. No. 92-1137, 92nd Cong., 2d Sess. 14 (1972).

Conclusion

The Title XI program has effectively and efficiently promoted the construction of thousands of vessels, in U.S. shipyards, which otherwise would not have been built, or would have been built abroad. It has done this by attracting private capital to the marine industry, at no cost to the U.S. taxpayer, with no discernible distortion of domestic or world credit markets. Title XI helps maintain a larger commercial shipbuilding base; promotes creation of a naval auxiliary reserve fleet for support of military operations in time of war; and generates a significant ripple effect in the overall economy. The program has been supported and improved under successive Republican and well as Democratic administrations. It deserves continued support, and in particular, removal of non-statutory annual ceilings on new commitments, and periodic prudent in-increases in authority from the current $9 billion (for non-fishing vessels).

Kominers, Fort, Schlefer & Boyer

---

[37] Act of July 10, 1973, Pub. L. 93-70, § 3, 87 Stat. 168.

[38] Act of Nov. 13, 1975, Pub. L. 94-127, § 5, 89 Stat. 68.

[39] Act of June 26, 1978, Pub. L. 95-298, § 5, 92 Stat. 240. Of that total, one billion dollars is reserved for fishing vessels. In addition in 1980, $2 billion of authority was added but reserved exclusively for guaranteeing obligations for construction of "commercial demonstration ocean thermal energy conversion facilities or plantships," Act of August 3, 1980, Pub. L. 96-320, § 203(b), 94 Stat. 974, so the effective authority for construction of commercial non-fishing vessels is at present $9,000,000,000.

EXHIBIT B

THE ECONOMIC IMPACT OF THE TITLE XI FEDERAL SHIP FINANCING GUARANTEE PROGRAM

Prepared for:

THE COMMITTEE FOR TITLE XI VESSEL FINANCING
SUITE 508
1776 F STREET, N.W.
WASHINGTON, D.C. 20006

Prepared by:

TEMPLE, BARKER & SLOANE, INC.
33 HAYDEN AVENUE
LEXINGTON, MASSACHUSETTS 02173

February 9, 1982

CONTENTS

Preface

Summary

I. OVERVIEW OF THE TITLE XI PROGRAM

II. THE ECONOMIC BENEFITS OF TITLE XI TO THE U.S. ECONOMY

III. TITLE XI AND THE FUTURE OF U. S. SHIPBUILDING

IV. IMPACT OF ALTERNATIVE FINANCING METHODS

V. COMPARISON OF TITLE XI WITH OTHER U. S. AND FOREIGN FINANCING PROGRAMS

VI. ADMINISTRATION OF THE TITLE XI PROGRAM

APPENDIX A: ECONOMIC IMPACT THEORY

PREFACE

THE COMMITTEE FOR TITLE XI VESSEL FINANCING

The Committee for Title XI Vessel Financing is a broad-based group of American shipbuilders and vessel operators deeply concerned about the future of the U.S. marine industry. Members of the Committee include major American shipyards included in the national defense base, as well as smaller, specialized yards; manufacturers that supply material and equipment to shipbuilders; and shipowners with U.S.-flag vessels deployed in the inland waterways, coastal and foreign trades. This broad participation reflects the critical importance of the vessel financing guarantees provided under Title XI of the Merchant Marine Act of 1936 to the shippers, shipowners and shipyards of this country.

The Committee was formed in order to seek a reversal of the Administration's recently-imposed cutbacks on the Title XI program. These cuts have reduced the volume of new guarantee commitments in FY1982 to the low level of $675 million. Simultaneously, the Administration has restricted the availability of Title XI for certain key vessel types, including offshore oil rigs. These vessels are a major component of present shipbuilding demand, and serve important needs in an international competitive environment. Title XI vessel construction is a key factor in maintaining U.S. shipbuilding capability for national defense. The recent fiscally counter-productive cuts should be restored, and the statutory limit on total guarantees outstanding will also need to be raised in the near future.

The Committee believes that any pre-fixed annual commitment ceiling is unnecessary and should be removed, so that Title XI can serve the market's current strong demand in a responsive manner. The statutory limit on total guarantees outstanding should in turn be increased to permit the continued vital activity of the program. The members of the Committee believe that the Title XI program is vital to the future of the U.S. shipbuilding and vessel operating industry, and that the program benefits numerous segments of the economy at no cost or significant risk to the federal budget.

THE OBJECTIVES OF THIS STUDY

The present study has been prepared to evaluate the economic impact of the Title XI Federal Ship Financing Guarantee program. Temple, Barker & Sloane, Inc., management and economic consultants, have been asked by the Committee to undertake an objective evaluation of the program's benefits to the U.S. economy. The analysis focuses upon program impact and performance to date, the future requirements for Title XI guarantees, and the impact of recently-imposed restrictions on annual new commitments.

SUMMARY

The Title XI Ship Financing Guarantee program has emerged as the most effective and attractive federal maritime program, promoting the growth and efficiency of the U.S. merchant marine's diverse sectors. It operates by providing a government guarantee for the repayment of debt contracted by shipowners for vessel acquisition. The funds are raised in the private capital market, and fees paid by program users have more than covered all costs to date. Title XI has successfully served U.S. taxpayers, shippers, shipowners and shipbuilders and has guaranteed, since its inception, more than 7,000 vessels worth over $13.2 billion at the time of construction. The Title XI program has played a central role in the expansion and modernization of the U.S. merchant fleet, and has generated broad benefits for the U.S. economy. The present study reviews Title XI's record in assisting ship construction and acquisition; estimates the magnitude of economic benefits generated throughout the economy by the program's operation; and assesses the potential economic costs of recently-imposed annual restrictions on the program. In reviewing the 44-year history of the program, its success is apparent in several ways:

THE TITLE XI PROGRAM HAS CONSISTENTLY SERVED ITS OBJECTIVES

The program has achieved its objective of providing U.S. shipowners with access to private capital markets at competitive interest rates and on terms that reflect the long lifetime value and service of the vessels.

THE PROGRAM HAS GUARANTEED PROJECTS OF THE HIGHEST QUALITY

By creating a portfolio of sound marine projects, Title XI helps shipowners tap the long-term capital markets for vessel finance. Title XI has supported projects of the highest quality, due to stringent approval criteria. This is evidenced by the extremely low rate of defaults and the fact that the program's contingent liabilities have never required funds from the Treasury or the taxpayer.

TITLE XI PROGRAM COSTS HAVE BEEN PAID BY ITS USERS

Throughout the program's life, users have paid for all the program's operating costs. These fees have generated the

Federal Ship Financing Fund, which today has retained earnings of $241 million. The full recovery of costs through user fees paid by shipowners advances the Reagan Administration's goal of allocating the expense of government services to the beneficiaries.

TITLE XI SUPPORTS NATIONAL DEFENSE SHIPBUILDING OBJECTIVES

The Title XI program has contributed significantly to the capacity, capability and efficiency of the nation's shipbuilding base. It has also increased the fleet of modern, efficient ships to support U.S. military logistical requirements. By promoting marine construction in U.S. yards, the skills, facilities and procedures to build ships effectively are preserved and the materials and services necessary to design and construct naval ships are supported. The fleet of barge carrying ships, containerships, roll-on/roll-off ships, tankers and bulk carriers and barges constructed with Title XI guarantees increase our military sealift and rapid deployment capabilities and the nation's ability to transport strategic material.

Without Title XI, the ability of U.S. yards to maintain skilled personnel, and to upgrade and maintain facilities would decrease. Fluctuations in naval shipbuilding demand would result in more extensive lay-offs and closures. The capabilities of the shipbuilding base would decline.

DEMAND FOR TITLE XI IS STRONG

The Title XI program continues to be in strong demand. At the beginning of FY1982, the active backlog of guarantee applications amounted to $3.5 billion of total project value, based on market demand for new vessels.

SINCE FY1970 THE TITLE XI PROGRAM HAS GENERATED A TOTAL ECONOMIC BENEFIT EQUIVALENT TO $77 BILLION

The magnification of benefits flowing from the Title XI program are a reflection of the extensive inter-industry linkages between shipbuilding and other economic sectors, and of the household expenditures generated as a result of direct and indirect worker incomes. Multipliers developed from national input-output data quantify the relationships between the direct impact of the program and the indirect (inter-industry) and induced (household expenditure) impacts. These impacts essentially measure the successive rounds of spending and re-spending throughout the economy in response to initial expenditures for vessel construction. Both the direct impact and the indirect effects of Title XI-assisted vessel construction are widely distributed along the coastal and inland regions of the country.

During the FY1970-FY1981 period, the Title XI program generated 277,000 man-years of shipyard employment. Approximately 1.2 million man-years of employment were generated throughout the economy by the program, considering the application of appropriate multipliers. The $16.3 billion (in 1981 constant dollars) of Title XI projects guaranteed during this period provided a total economic benefit to the economy of $76.6 billion (1981 dollars), based on applicable multipliers.[1]

The operation of the fleet of vessels built with the aid of Title XI guarantees also provides revenues and employment over the lifetimes of these vessels. The program has the potential to continue to support a broad base of industrial, wholesale and retail employment.

THE CURRENT CEILINGS CURTAIL THE EFFECTIVENESS OF THE TITLE XI PROGRAM

The ability of the Title XI Program to assist in financing American marine projects has been sharply curtailed by the annual ceilings imposed by the Administration in FY1981 and FY1982 on new guarantee commitments. A new guarantee ceiling of $675 million has been set for FY1982. This amount is far below the needs of the nation's shippers, customers, shipowners and shipbuilders:

- The imposition of annual ceilings is unprecedented and limits the program's ability to respond to the needs of the market, artificially dampening demand for vessel construction;
- $675 million is less than one-half of the annual amount necessary to provide guarantees to the $3.5 billion of current and active applications;
- Measured in real terms, the FY1982 ceiling is only 55 percent of the average annual guarantees approved during the FY1979-FY1981 period and less than one-third of the largest annual amount;
- The $675 million of annual guarantees now authorized will be offset by an estimated $350 million in principal repayments during FY1982. The net additional $325 million in outstanding guarantees means that the total outstanding guarantees of the program will decrease in real terms.

---

[1] This report generally expresses dollar values covering a period of time in constant-price terms (1981 dollars), to facilitate inflation-adjusted comparisons. Constant-price measurement of value is indicated specifically in each case. Other dollar figures are in current (nominal) terms.

PROJECTS WORTH NEARLY $2.0 BILLION ARE EXPOSED TO DELAY AND CANCELLATION

Approximately $1.9 billion (1981 dollars) in current active projects cannot be accommodated under the administrative ceiling during the next two years. Nearly one-half of this business could legally be placed with foreign shipyards and operated with foreign crews, costing the U.S. economy both jobs and foreign exchange. For those vessels which are required to be built in the U.S., the financial markets are not structured to provide capital at rates and on terms equivalent to those obtainable with Title XI guarantees. This will delay or cancel the projects and result in higher-cost, less efficient transportation for American industry. The $1.9 billion (1981 dollars) of jeopardized demand will expose more than 31,000 man-years of shipyard labor to potential lay-off.

The $1.9 billion in projects that cannot be guaranteed threatens $9.1 billion (1981 dollars) and 133,000 jobs throughout the economy. This loss recognizes the relationships between shipyards, their suppliers and the general economy. For every lost shipyard job, an additional 3.3 jobs are lost in the economy. For every foregone shipbuilding dollar, an additional $3.80 of revenues are lost through reduced supplier and household spending in the economy. It is imperative that the administrative ceiling on annual authorizations be abolished so that the program can respond to strong current market demand.

The Administration has also established guidelines that exclude offshore drilling rigs from the Title XI program. These vessels represent a major component of the U.S. shipbuilding and Title XI applications backlog. A major portion of the U.S.-built drilling rig fleet is competing in foreign waters, and contributing to the U.S. balance of payments. Because offshore oil operations in U.S. waters are not protected by the Jones Act, any restriction on the availability of financing for U.S.-built drilling rigs could induce foreign construction of vessels for operation in U.S. waters. Potential exports of services as well as U.S. shipyard activity are seriously jeopardized by excluding these categories of vessels.

Title XI vessel financing guarantees do not constitute hidden subsidies to major corporations. Large corporations can obtain financing at lower interest rates without the Title XI guarantee. Rather, they permit independent vessel operators to obtain financing at market-determined rates plus a guarantee fee, and enhance the level of competition and flexibility in the marketplace for transportation services.

The statutory ceiling on the program could also pose a constraint to its continued effectiveness. This total ceiling on Title XI guarantees is currently $9.9 billion and has been declining in real value terms. Current market demand for Title XI mortgage guarantees, as expressed by the backlog of active applications, would exceed the ceiling. It is therefore important that Congress increase the total guarantee authorization.

The Title XI program is a vital means to permit U.S. industries to have efficient vessel services and to facilitate the demand for shipbuilding services in the current period of economic recession and national policy formulation. U.S. shipyards need to be able to respond to owner demands rapidly in order to maintain their productivity and national defense status. The current transition away from subsidized construction makes it imperative that Title XI be permitted to respond to market demand and facilitate all types of quality marine projects.

I. OVERVIEW OF THE TITLE XI PROGRAM

The Title XI Ship Financing Guarantee program is a uniquely effective and attractive federal maritime program, from the viewpoint of U.S. shipowners, shipbuilders and taxpayers. Created in 1938 as an amendment to the Merchant Marine Act, 1936, the program is administered by the U.S. Department of Transportation's Maritime Administration. Today, the Title XI program has become the most significant and successful American maritime promotional program. This chapter provides an overview of Title XI's purpose and operating methods; the broad range of vessel types assisted; and the strong market demand for the program, both historically and at present.

TITLE XI GUARANTEES PRIVATE SECTOR CAPITAL

Title XI achieves its goals of promoting the growth of the U.S. merchant marine and the utilization of American shipyards by guaranteeing commercial loans to finance vessel construction. The program does not itself extend loans or subsidies to shipowners or shipbuilders. It enables owners of eligible vessels to obtain access to long-term, fixed rate funds from the private capital markets, at interest rates comparable to those obtained by Aa-rated corporations. The Maritime Administration guarantees prompt repayment of bond obligations issued by the shipowner in the private capital markets. The Government's guarantee is secured, in turn, by a first preferred mortgage on the vessel and by stringent conditions. The amount guaranteed cannot, by law, exceed 75 percent of the subsidized vessel cost, and in other cases the proportion can be 87.5 percent. Title XI ship mortgage guarantees are available for a maximum period of up to 25 years from the vessel's date of delivery and are consistent with the expected economic and operating lives of the guaranteed vessels. Short-term guarantees of interim financing during the ship's construction period are also available.

TITLE XI HAS COST THE TAXPAYERS NOTHING

During its 44 year history, the program has been totally funded by its direct users. Fees paid by shipowners--initial filing and investigation fees, and annual guarantee fees--are deposited by the Maritime Administration in a Federal Ship Financing Fund to underwrite the program and pay all expenses. Since its initial establishment with $1 million of federal seed money, this fund has not received any federal funds. Rather, the fund has built up retained earnings of $241 million, after payment of all administrative expenses and the few claims to date. Though the Maritime Administration has a contingent call on the U.S. Treasury to honor the guarantees, this has never been exercised in the history of the program.

ONLY QUALITY PROJECTS CAN BE GUARANTEED

Consistent with the statutory requirement that only economically sound projects be guaranteed, a highly skilled and experienced team of Maritime Administration specialists examines and must approve each application for a Title XI guarantee (see Chapter VI for details). The economic soundness of the proposed vessel operation is closely scrutinized before approval is granted, and changes in the proposal are often sought to ensure commercial viability. Financial, market, operational and contractual aspects of each project are reviewed, and appropriate conditions are set for the guarantee. The asset value of the vessel is protected by requiring that applicable Coast Guard and American Bureau of Shipping certificates be obtained and kept up-to-date.

Because the Title XI program requires that guaranteed projects be economically sound, the Office of Management and Budget annual guarantee authorization ceiling is unnecessary. If the Maritime Administration analysis indicates that an applicant seeks to deploy a new vessel in a market that is not sound, the application is denied. This statutory requirement creates and maintains a market-based ceiling. Because of this internal ceiling, it is critical to the program's effectiveness that guarantee authority be available to respond to market demand.

GUARANTEES EXTEND TO ALL SECTORS OF THE MERCHANT MARINE

Vessels financed with the assistance of Title XI represent the entire range of the U.S. merchant fleet. This coverage is much broader than it was at the beginning of the 1970s (see Exhibit I-1). At the outset of the decade, 98 percent of the guarantee value was concentrated in the tanker, cargo, and cargo/passenger ship categories. By the end of FY1981, these vessel types accounted for only 48 percent of cumulative Title XI guarantees. The types of projects guaranteed by Title XI have expanded to include river towboats and barges to transport coal, grain and petroleum to domestic and export facilities; ocean tugs and barges to distribute oil, coal, fertilizer and general cargoes; offshore rigs and service vessels to discover and develop energy sources; and liquefied natural gas carriers to import needed methane gas. U.S. merchant vessels costing some $16.3 billion, in constant 1981 dollars, were constructed with the assistance of Title XI financing guarantees between FY1970 and FY1981 (see Exhibit I-2).

Prospects for the future are equally diversified. The composition of MarAd's current active applications, as of October 1, 1981, indicates the continued importance of the offshore, inland and ocean tug and barge sectors (see Exhibit I-3). Due to the very much reduced likelihood that U.S.-flag foreign trading ships will be ordered in the next several years, due to the suspension of the Construction Differential Subsidy program, the role of Title XI as an effective and responsive means to promote U.S. shipbuilding is even more important.

DEMAND FOR TITLE XI CONTINUES TO BE STRONG

Between FY1970 and FY1981, the outstanding principal value of Title XI guarantees in force increased from $0.9 billion to $7.9 billion, as the program supported the expansion and modernization of the U.S. merchant vessel fleet. The backlog of active applications has also increased. But the statutory ceiling for total guarantees outstanding has not been raised since FY1978, and has effectively declined in real terms. Exhibit I-4 presents these historical trends, including the potentially restrictive nature of the statutory ceiling. Title XI's future is discussed in Chapter III.

The value of total guarantees outstanding in recent years has not increased in real terms (see Exhibit I-5). After reaching an all-time peak of $8.2 billion in FY1977, the real value of guarantees in force (measured in constant 1981 dollars) has not exceeded $8.0 billion. In earlier years, fluctuations in market conditions and industry demand for guarantees were responsible for the level of new commitments approved. The imposition of a $675 million ceiling on new Title XI commitments during FY1982, by the Office of Management and Budget, will result in artificially-reduced demand, as indicated in Exhibit I-5.

Exhibit I-1

CUMULATIVE COMPOSITION OF THE TITLE XI GUARANTEED FLEET

	Number of Vessels Guaranteed		Cost to Owners Millions of Dollars		Cost to Owners Percent of Total	
	Through FY1970	Through FY1981	Through FY1970	Through FY1981	Through FY1970	Through FY1981
Tankers	48	125	$567	$3,640	37%	27%
Cargo Ships	120	214	836	2,667	54	20
Cargo/Passenger Ships	10	10	105	105	7	1
River Tugs	2	128	1	211	—	2
River Barges	8	2,470	3	625	—	5
Ocean Tugs	1	138	4	418	—	3
Ocean Barges	6	187	17	646	1	5
Shipboard Barges	360	3,546	8	191	—	1
Miscellaneous Vessels	3	22	13	228	1	2
Offshore Drill Rigs	—	95	—	1,840	—	14
Offshore Support Vessels	—	205	—	515	—	4
Liquefied Natural Gas Carriers	—	16	—	1,566	—	12
Dry Bulk Carriers	—	21	—	549	—	4
Total	558	7,177	$1,547	13,201	100%	100%

Source: U.S. Maritime Administration, Office of Ship Financing Guarantees.

Exhibit I-2

COMPOSITION OF TITLE XI GUARANTEES IN FORCE APPROVED DURING THE FY1970-FY1981 PERIOD

AS OF OCTOBER 1, 1981

(millions of dollars)

		New Construction & Reconstruction Guaranteed		
Vessel Type	Guaranteed Number of Vessels	Total Cost to Owner (current dollars)	Title XI Guarantee (current dollars)	Total Cost to Owner (1981 Dollars)
Inland Tank	234	$142.8	$120.3	$192.9
Inland Dry Bulk Barges	2,066	392.1	328.7	527.7
Inland Towboats	121	221.1	167.4	330.4
Dredges	10	135.5	110.0	166.6
Domestic Liners	19	518.8	417.5	821.7
Great Lakes	23	550.6	459.2	875.6
Domestic Ocean-Tank	129	2,289.4	1,930.5	3,151.5
Domestic Ocean-Dry Bulk	16	134.4	120.5	186.8
Harbor Craft	3	4.9	3.6	6.7
National Defense	11	215.7	167.2	372.4
Domestic Passenger	—	--	--	--
Drydocks	1	25.6	20.9	43.8
Offshore Industry	313	2,456.2	1,863.9	3,455.3
LASH Barges	2,121	118.4	96.5	197.9
Liner Ships	93	1,225.9	883.0	1,960.6
Tankers--Crude and Product	27	517.7	384.6	943.8
Tankers--Special Purpose	3	103.8	77.7	115.2
Tankers--LNG	16	1,733.6	1,400.0	2,772.4
Drybulk	7	110.7	82.9	163.6
Total	5,213	10,897.2	8,634.4	16,284.9

Source: TBS analysis of Maritime Administration Contracts in Force.

Exhibit I-3

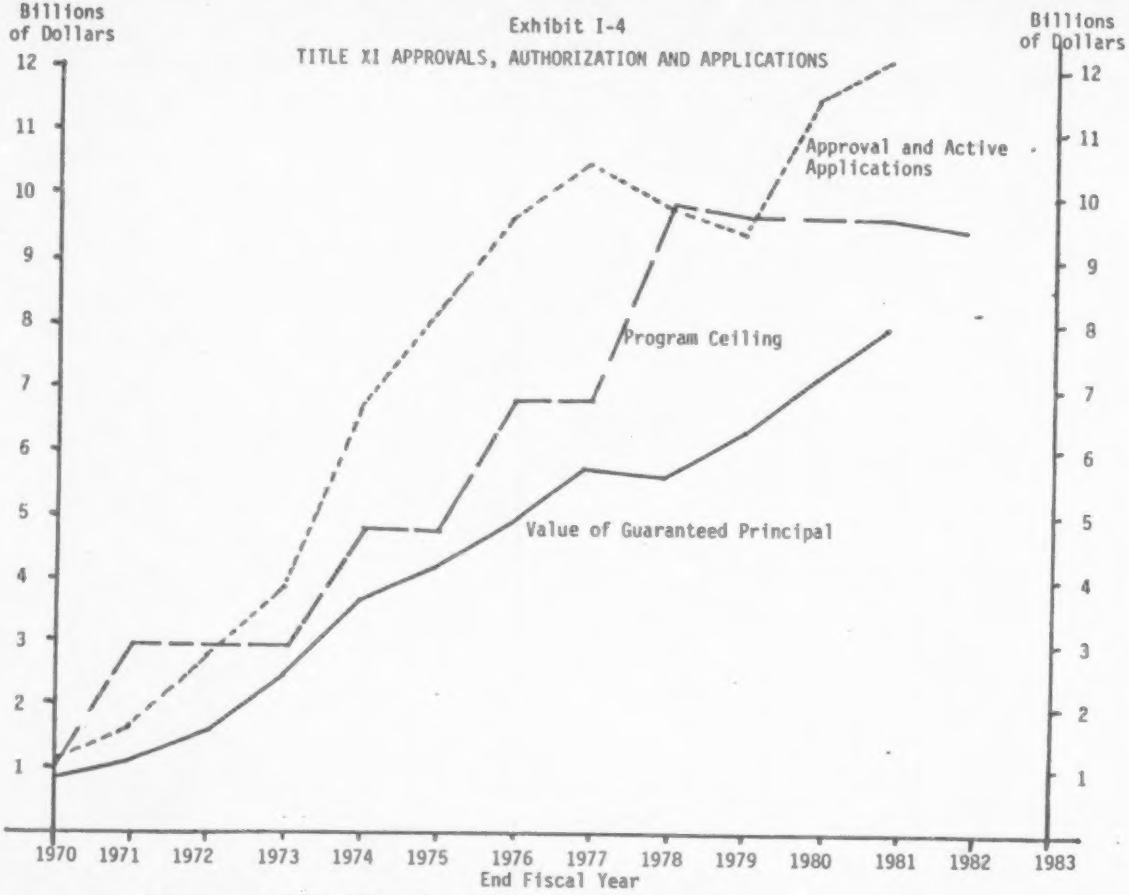
COMPOSITION OF TITLE XI ACTIVE APPLICATIONS
AS OF OCTOBER 1, 1981
(millions of dollars)

		New Construction & Reconstruction Active Applications		
Vessel Type	Applications No. of Vessels	Total Cost to Owner (current dollars)	Title XI Guarantee (current dollars)	Total Cost to Owner (1981 Dollars)
Inland Tank	34	$36.1	$31.5	$39.3
Inland Dry Bulk Barges	1,726	527.0	438.7	545.9
Inland Towboats	42	78.0	60.6	82.4
Dredges	4	45.8	35.7	49.0
Domestic Liners	2	8.5	7.4	9.4
Great Lakes	3	51.2	44.8	56.9
Domestic Ocean-Tank	24	826.2	723.1	907.9
Domestic Ocean-Dry Bulk	20	96.6	78.2	97.4
Harbor Craft	16	60.7	50.5	65.0
National Defense	2	54.0	40.5	59.9
Domestic Passenger	1	95.1	80.0	105.6
Drydocks	--	--	--	--
Offshore Industry	122	1,608.9	1,209.2	1,688.2
Total Active Applications	1,996	3,488.1	2,800.2	3,706.0

Source: TBS analysis of Maritime Administration Contracts In Force.
17 ships and 409 LASH barges with a total cost to owner of $1.4 billion which would serve in the foreign trades have been excluded due to the suspension of Construction Differential Subsidy funding.

Exhibit I-4

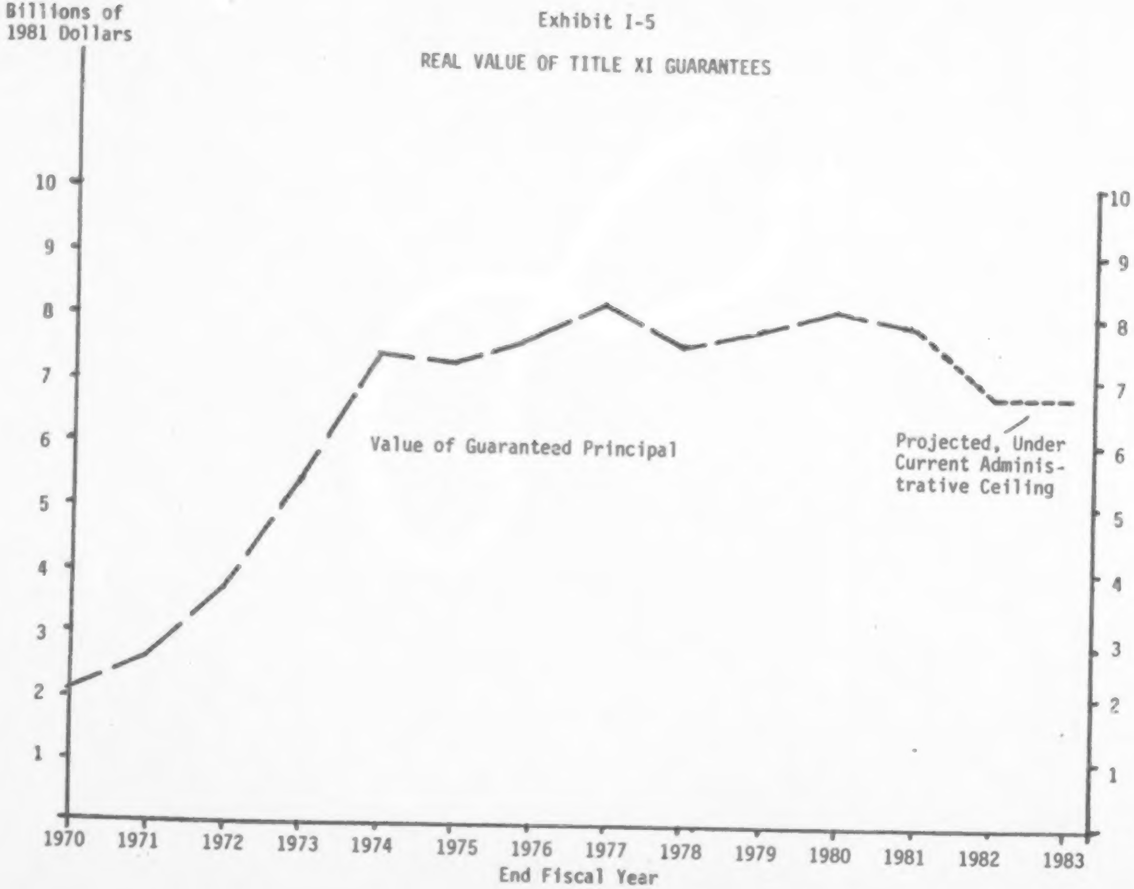
TITLE XI APPROVALS, AUTHORIZATION AND APPLICATIONS



Source: Maritime Administration.

Exhibit I-5

REAL VALUE OF TITLE XI GUARANTEES



II. THE ECONOMIC BENEFITS OF TITLE XI TO THE U.S. ECONOMY

Vessel construction and reconstruction financed with the aid of Title XI guarantees generates significant revenues, payrolls, and employment in virtually all sectors of the U.S. economy. The $16.3 billion of marine equipment (1981 constant dollars) financed with the aid of the Title XI Program between FY1970 and FY1981 generated total revenues of $76.6 billion (1981 dollars) throughout the economy, considering the direct, indirect, and induced impacts. A total of 1.2 million man-years of employment were also created. Title XI's "Buy American" provision encourages owners and shipyards to specify U.S.-made material and machinery, since the program generally does not cover foreign-made parts.

TITLE XI SHIPBUILDING GENERATES $4.70 PER DOLLAR OF PROJECT VALUE

The revenues and jobs generated by Title XI ship construction and reconstruction projects are widely spread through the economy because the shipbuilding industry purchases inputs from a wide variety of other U.S. industrial sectors. In addition, shipbuilding employees spend their salaries purchasing consumer goods from various industrial and service sectors. These complex inter-industry relationships and the successive rounds of household expenditures, magnify and extend the benefits of shipbuilding to the U.S. economy. It is estimated that each dollar of shipbuilding contract value creates a total of $4.70 of revenues in the U.S. economy, based on analysis of national input-output data (see Appendix A for a summary of the theory underlying the economic impact analysis).

Title XI shipbuilding generates three distinct types of positive impacts on the U.S. economy. These are:

- Direct impacts--the wages, other costs and profit generated within shipyards (termed the "value-added") plus the materials purchased by shipyards to construct vessels. The direct impact of Title XI shipbuilding is equal to the value of the projects and the shipyard employment generated. For the FY1970-1981 period, $16.3 billion (in 1981 dollars) in revenues and 277,000 man-years of shipyard employment were generated by Title XI projects exclusive of the Construction Differential Subsidy Program. An annual average of 23,100 jobs in the industry can be attributed to the program. Exhibit II-1 identifies the purchases and direct shipbuilding value-added that were generated during the twelve-year period. Shipbuilding purchases 47 percent of its output from suppliers for installation aboard vessels. Steel, machinery, piping, engines, turbines, lumber, and a wide range of materials are included. Nearly $7.7 billion (in 1981 dollars) of materials and services were purchased for Title XI projects.

- Indirect Impact-- the goods and services purchased by suppliers to produce materials which are sold to shipyards, and the successive rounds of inter-industry purchases. Industries represented include manufacturers of steel plate, cable, electronics, and mechanical and electronic equipment, who sell goods and services to suppliers of the shipbuilding sector. Services including craftsmen, engineers, bankers and realtors are also purchased by suppliers to the shipbuilding industry. For each dollar of direct revenues, of which about half goes to direct suppliers, another dollar of indirect revenues is generated. For each shipyard employee, 0.8 jobs are created in industries supplying shipbuilding. During the FY1970-1981 period, $16.3 billion (in 1981 dollars) in indirect benefits and 222,000 manyears of employment were generated. The combined impact of the Title XI program in terms of direct and indirect revenues and employment during the 12-year FY1970 to FY1981 period was $32.6 billion 1981 dollars and 498,800 manyears of employment. Exhibit II-2 identifies the composition of the direct and indirect benefits generated by the Title XI program.

- Induced Impact--the income effects that result when the wages and salaries of the direct and indirect employees are spent by their households and are then re-spent throughout the economy. For each dollar of direct and indirect benefit, $2.70 is generated as an in duced benefit. Therefore, total revenues of $4.70 are generated for each dollar of Title XI shipyard project:

--$1.00 for the shipyard value-added and direct suppliers;
--$1.00 indirectly for other industrial suppliers;
--$2.70 induced by the direct and indirect incomes which are re-spent through the economy;
--Total = $4.70 per dollar of Title XI project.

In addition to financial benefits, each of the Title XI shipbuilding project jobs generates a total of 4.3 jobs:

--1.0 directly in the shipyard;
--0.8 indirectly at suppliers;
--2.5 induced by the direct and indirect incomes generated in the economy;
--Total = 4.3 jobs per shipyard job.

The combined direct, indirect and induced impact of the Title XI Program is presented by major impacted industry in Exhibit II-3. A wide range of industrial and service sectors were stimulated, including:

- $8.5 billion (1981$) of general services;
- $7.9 billion of finance, insurance and real estate services;
- $6.6 billion of wholesale retail services;
- $4.1 billion of food products and tobacco;
- $3.0 billion of primary iron and steel industries;
- $2.0 billion of transportation services; and
- $2.0 billion of textiles and apparel.

BETWEEN FY1970 AND FY1981 THE TITLE XI PROGRAM GENERATED 1.2 MILLION MAN-YEARS OF EMPLOYMENT AND $76.6 BILLION IN THE ECONOMY

The benefits of Title XI can be measured in terms of total output (revenue), employment and payroll. Exhibit II-4 identifies the combined direct, indirect, and induced components of the benefits over the FY1970-FY1981 period. More than 1,190,000 man-years of employment, an average of 99,000 jobs annually, were generated by the Title XI guarantee program during this period.

TITLE XI SHIPS GENERATED AN ESTIMATED $4.8 BILLION IN OPERATING REVENUES DURING 1980 AND EMPLOYED 37,000 PERSONS ON BOARD AND ASHORE WITH A $900 MILLION PAYROLL

The Title XI fleet generated an estimated $4.8 billion in revenues during 1980, based upon an analysis of the financial performance of inland, ocean and offshore carriers as shown in Exhibit II-5. Deepwater cargo liners, bulk carriers and tankers generated more than $3.0 billion, offshore drilling rigs and service vessels generated nearly $1.0 billion, and the inland and ocean towing and barge fleets each generated more than $500 million per year. U.S. vessels built with the assistance of Title XI guarantees also employed about 37,000 persons, ashore and afloat (see Exhibit II-6). This is a benefit indirectly linked to the Title XI program, but is also an impact that continues over the entire life of the vessels constructed.

The Title XI fleets provide vital and diverse services to their customers--transporting coal, grain and petroleum products on the inland waterways, delivering crude oil from Valdez, Alaska to U.S. refineries, transporting U.S. foreign commerce to and from abroad, and assisting in the exploration and development of offshore oil and gas.

TITLE XI HAS SUPPORTED PROJECTS IN ALL REGIONS OF THE NATION

During the FY1970-1981 period, the Title XI program supported projects that closely reflected total merchant shipbuilding demand. The Title XI program is estimated to have guaranteed shipyard projects in the four major regions of the nation, as summarized in Exhibit II-7. Gulf Coast yards, which have traditionally served the offshore, inland, coastwise and foreign-trading segments, built 48 percent of the Title XI guarantee projects, followed by the Atlantic (22 percent), Pacific (13 percent), Inland states (6 percent) and Great Lakes (5 percent).

Exhibit II-1

DIRECT IMPACT OF TITLE XI SHIPBUILDING ON SELECTED INDUSTRIES

FY1970-FY1981

Supplier Industry	Input (¢) per $ of Output[1]	Input over FY1971-81 Period Millions of Constant 1981 $
Primary Iron and Steel	8.7	1,418
Machinery and Equipment	5.1	831
Heating, Plumbing, Struc. Metal	3.8	619
Services	3.7	603
Wholesale and Retail	3.1	505
Engines and Turbines	2.6	424
Lumber and Wood	2.0	326
Primary Non-ferrous Metal	1.9	310
Other Fabricated Metal	1.8	293
Instruments	1.1	179
Other Industries	13.2	2,152
Total Suppliers	47.0	7,661
Shipbuilding Value Added	53.0	8,639
Total Output	100.0	16,300

[1] Based on 1972 data.

Source: TBS analysis of Chung, Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978 (1981), and Maritime Administration data.

Exhibit II-2

DIRECT AND INDIRECT (INTER-INDUSTRY) IMPACT OF TITLE XI SHIPBUILDING

Supplier Industry	Input (¢) per $ of Output	Input over 1970-1981 Period Million Constant 1981 $
Primary Iron and Steel	15.4	$2,445
Services	8.0	1,270
Machinery and Equipment	7.3	1,159
Other Electrical Equipment	6.7	1,064
Primary Non-ferrous Metal	6.1	968
Wholesale and Retail	5.9	937
Heating, Plumbing, Struc. Metal	4.1	651
Finance, Insureance, and Real Estate	3.9	619
Engines and Turbines	3.1	492
Other Fabricated Metal	3.7	587
Lumber and Wood	3.2	508
Other Transportation	3.5	556
Other Industries	26.5	4,207
Total Suppliers	97.4	$15,463
Shipbuilding Industry	100.0	16,330
Total Output	197.4	$32,600

Source: TBS analysis of Chung, Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978 (1981), and Maritime Administration data.

Exhibit II-3

DIRECT, INDIRECT AND INDUCED ECONOMIC IMPACT OF TITLE XI SHIPBUILDING
During the FY1970 to FY1981 Period

Impacted Industry	Production (¢) per $ of Shipbuilding Output	Impact on 1970-1980 Period, Million Constant 1981 $
Services	53.1	$8,655
Finance, Insurance, and R. E.	49.1	8,003
Wholesale-Retail	40.9	6,667
Food Products and Tobacco	25.3	4,124
Primary Iron and Steel	18.5	3,016
Other Transportation	12.6	2,054
Textiles and Apparel	12.4	2,021
Other Transport Equipment	11.3	1,842
Other Electrical Equipment	11.1	1,809
Utilities	10.6	1,728
Macninery and Equipment	8.8	1,434
All Other Industries and Services	116.3	18,957
Shipbuilding Industry	100.0	16,300
TOTAL	470.0	76,610

Source: TBS analysis of Chung, Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978 (1981), and Maritime Administration data.

Exhibit II-4

ECONOMIC IMPACT OF TITLE XI PROGRAM, During the FY1970-1981 Period (constant 1981 dollars)

	--------Type of Impact----------		
	Direct	Direct and indirect	Direct indirect and induced
Output Multiplier	--	2.0	4.7
Output, $ Millions	16,300	32,600	76,610
Output, Annual Average ($mm)	1,358	2,717	6,384
Employment Multiplier	--	1.8	4.3
Employment, Man-Years	277,100	498,800	1,191,500
Employment, Annual Average	23,100	41,600	99,300
Payroll Multiplier	0.34	1.8	3.8
Payroll, $ Millions	5,542	9,976	21,060
Payroll, Annual Average ($mm)	462	831	1,756

Source: TBS analysis of Chung, Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978, and of Maritime Administration data.

Exhibit II-5

CALCULATION OF REVENUE AND PAYROLL OF TITLE XI FLEET IN THE YEAR 1980
(Current dollars, millions)

Vessel Type	Vessel Actual Cost[2]	Revenue Factor	Revenue Generated
Cargo Ships & Miscellaneous	2,285.9	60	1,371.5
Tankers	2,786.7	30	836.0
Great Lakes	425.3	40	170.1
LNG Ships[1]	880.9	30	264.3
Ocean Tugs, Barges	920.5	70	644.4
River Tugs, Barges	636.5	80	509.2
Drilling rigs	1,515.4	50	757.7
Drill Service Vessels	385.1	55	211.8
Total	9,836.3		4,765.0
Total payroll generated at 18.9% of output[3] =			900.6

[1] Nine LNG ships were active in 1980.

[2] Includes all vessels built with Title XI from FY70 through FY80, except in the case of LNG ships.

[3] Employee compensation as percentage of revenue, from Chung.

Source: TBS analysis of vessel operators 1980 results, and of Maritime Administration data on Title X1 vessel original costs, counting bulk ships as Great Lakes vessels.

Exhibit II-6

CALCULATION OF EMPLOYMENT
IN TITLE XI FLEET, 1980

Vessel Type	Number of Vessels, 1980[1]	Average Crew Size Per vessel	Average Crew Members Per Job	Factor for Shoreside Jobs	Total Employment
Cargo Ships	127	43	1.5	1.25	10,239
Tankers	75	37	1.75	1.10	5,342
Great Lakes	18	32	1.2	1.15	795
LNG Ships	9	35	2.0	1.15	725
Ocean Tugs	132	8	2.0	1.15	2,429
River Tugs	116	10	1.5	1.15	2,001
Drilling Rigs	76	70	2.0	1.15	12,236
Drill Service Vessels	167	8	2.0	1.15	3,073
Total	720				36,840

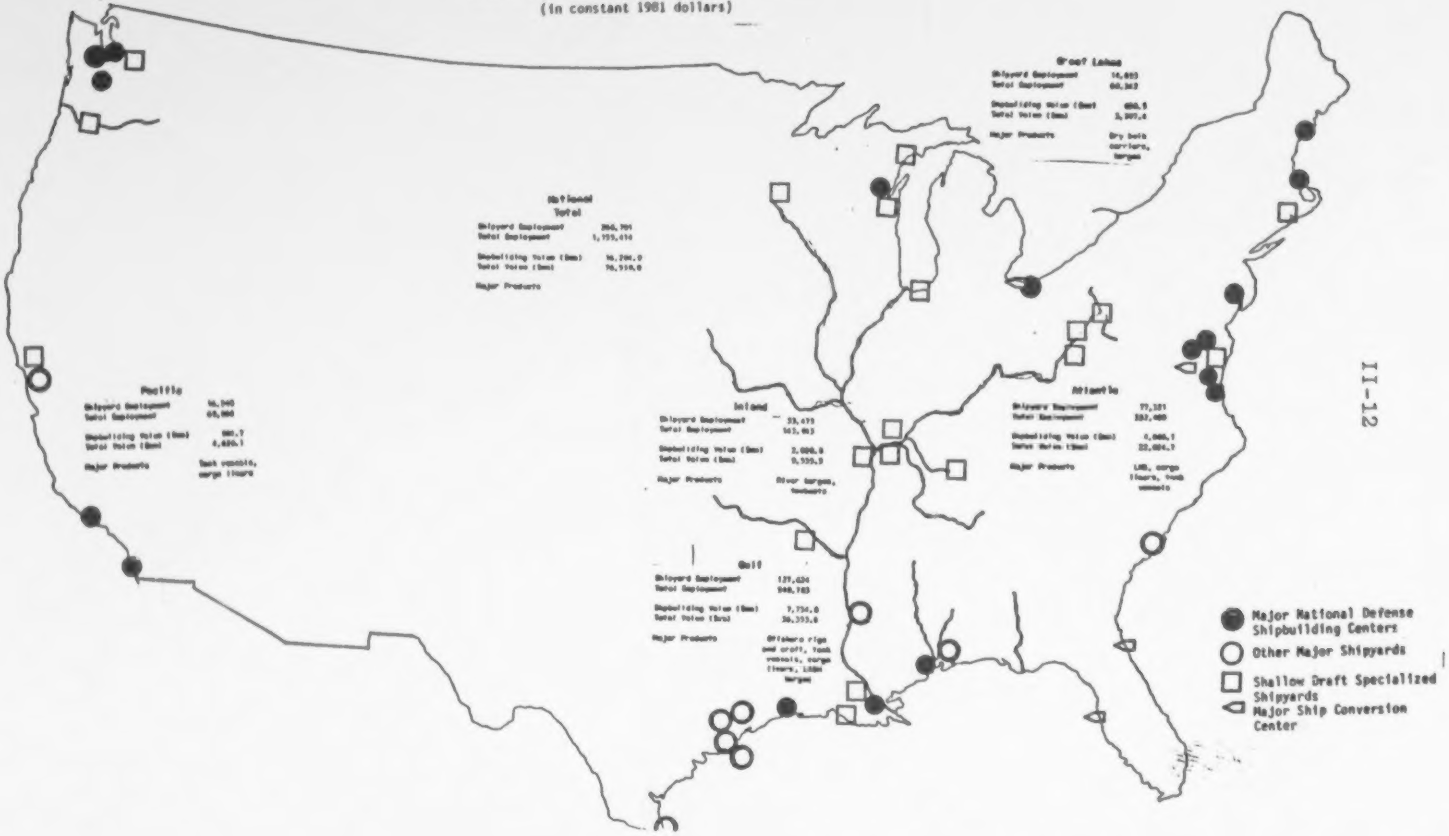
[1] Number of vessels includes all vessels whose Title XI applications were approved from FY70 through FY80.

Source: TBS analysis of Maritime Administration data and estimates of general industry practice.

Exhibit II-7

REGIONAL DISTRIBUTION OF VESSEL CONSTRUCTION WITH TITLE XI GUARANTEES, FY1970 THROUGH FY1981

(in constant 1981 dollars)


Great Lakes
Shipyard Employment 16,833
Total Employment 60,362
Shipbuilding Value ($mm) 666.5
Total Value ($mm) 3,307.4
Major Products Dry bulk carriers, barges
National Total
Shipyard Employment 266,701
Total Employment 1,155,414
Shipbuilding Value ($mm) 16,204.0
Total Value ($mm) 76,550.0
Major Products
Pacific
Shipyard Employment 16,340
Total Employment 65,966
Shipbuilding Value ($mm) 980.7
Total Value ($mm) 4,426.1
Major Products Tank vessels, cargo liners
Inland
Shipyard Employment 33,479
Total Employment 163,813
Shipbuilding Value ($mm) 2,090.8
Total Value ($mm) 9,555.3
Major Products River barges, towboats
Atlantic
Shipyard Employment 77,321
Total Employment 382,400
Shipbuilding Value ($mm) 4,066.1
Total Value ($mm) 22,004.7
Major Products LNG, cargo liners, tank vessels
Gulf
Shipyard Employment 127,634
Total Employment 548,783
Shipbuilding Value ($mm) 7,734.0
Total Value ($mm) 36,393.6
Major Products Offshore rigs and craft, tank vessels, cargo liners, LASH barges
● Major National Defense Shipbuilding Centers
○ Other Major Shipyards
□ Shallow Draft Specialized Shipyards
◁ Major Ship Conversion Center

III. TITLE XI AND THE FUTURE OF U.S. SHIPBUILDING

The Title XI program has been effective because it has responded to market requirements for financial guarantees on high quality marine projects. During the 1970s, the program was able to support shipowners' requirements and to help sustain shipyard capacity. The authorized guarantee approval ceiling of $675 million for FY1982 and the restriction of vessel types is unprecedented and will constrain owners' ability to contract for ships during FY1982. The ceiling is substantially lower than recent approval levels and current demand. This decrease occurs at a time when U.S. shipbuilding contracts are critical to owners and to the shipbuilding industry. Because the demand for guarantees fluctuates from year to year, it is important that the Program's annual new commitments be allowed to respond flexibly, up to its statutory limits. The annual authorization ceiling must therefore be eliminated.

This chapter assesses the past trends and present backlog in Title XI guarantee applications. The strong demand for Title XI guarantees is analyzed by vessel type. Set against the $675 million ceilings for new commitments in FY1982 and FY1983, a substantial loss of shipyard business is foreseen, and its impact throughout the economy is quantified.

THE FY1982 AUTHORIZATION CEILING IS SHARPLY LESS THAN RECENT LEVELS

During the FY1979-FY1981 period, MarAd Title XI approvals averaged $1.1 billion 1981 dollars, after fluctuating widely during the 1970s. The Administration's new commitment ceiling of $675 million for FY1982 represents only 55 percent of the average real authorizations available compared to the three prior years. The limit therefore poses a very sudden and serious threat to U.S. shipowners and shipyards. Because of continued strong demand for guarantees at this time, the ceiling poses an artificial constraint on market activity.

The current FY1982 ceiling of $675 million will result in a net decline of guaranteed principal outstanding in real terms. Some $1.2 billion would be needed in FY1982 to merely maintain the outstanding guarantee value of the program at its current level. This is because new commitments will be partially offset by repayment of an estimated $350 million in loan principal during FY1982.

THE FY1982 NEW COMMITMENT CEILING IS FAR BELOW THE LEVEL NECESSARY TO MEET CURRENT DEMAND FOR U.S.-FLAG VESSELS

MarAd's active applications for Title XI guarantees totaled $3.5 billion at the beginning of FY1982. The composition of the applications is presented in Exhibit III-3 and summarized below.

Table III-1

ACTIVE TITLE XI GUARANTEE APPLICATIONS
As of October 1, 1981
(Billions of Dollars)

	Total Cost to Owner	Guarantee Amount
Domestic Ships and Barges	1.9	1.6
Offshore Ships and Rigs	1.6	1.2
Total	3.5	2.8

NOTE: Excludes applications for foreign-trading vessels with a total cost to owner of $1.4 billion and guarantee amount of $1.0 billion due to the suspension of the CDS program.

Source: TBS analysis of MarAd information.

The $3.5 billion of domestic and offshore applications are urgent and in many cases tied to construction in progress. These applications are being approved by MarAd as funds become available.

The domestic and offshore vessels comprise a $3.5 billion base of Title XI applications. The status of these projects indicates that guarantee approval within two years must occur to avoid disruption of delivery schedules and market requirements. At least $1.8 billion of projects must be approved each year. This is roughly equivalent to $1.35 billion per year in Title XI guarantees, based on 75 percent coverage. This sum is roughly double the current annual ceiling of $675 million, and is close to the approval levels of recent years.

The domestic and offshore applications are critical to the national objectives of increasing the efficiency of U.S. transportation and of securing alternate sources of energy in a deregulated environment. The domestic and offshore applications have a total project value of $3.5 billion with the following major components:

Offshore Industry

Applications for $1,600 million--This largest segment of Title XI demand is composed of offshore drilling rigs, service ships including supply, crew, and survey boats, and offshore service tugs and barges. The industry is almost exclusively based upon relationships between independent owner/operators that provide equipment to oil and gas companies. This structure has permitted a free and efficient market to exist and has supported the U.S. offshore activities in domestic waters and overseas.

The demand for offshore drilling rigs and service vessels is strong worldwide, but U.S. dominance in this market is eroding due to intense price competition by Scandinavian and Far East shipyards. The decisions to construct equipment for the overseas markets in U.S. yards are based on cost and capacity. In the near future, the Title XI program will be a critical factor to permit U.S. yards to maintain their competitiveness and production efficiency and to offset some of the effects of extensive foreign subsidies. U.S. yards on the Gulf and Atlantic coasts in Texas, Louisiana, Mississippi, Alabama, South Carolina, and Maryland are competing in this worldwide market.

Offshore service craft are almost all independently owned and tend to be built by small yards dedicated to these craft. Shipyards in Rhode Island, Florida, Alabama, Mississippi, Louisiana, Texas and California are active in U.S. offshore service craft production.

Domestic Ocean Tank Vessels

Applications for $800 million--This construction is comprised of coastal tankers and large oceangoing barges and tugs. This construction will increase the efficiency of petroleum product and petrochemical distribution, increase the environmental safety of the U.S. fleet, and provide high-performance world-standard tankers for national security if required. This activity will permit the replacement of many over-age, high-cost tankers constructed during World War II. Shipyards in Maine, Massachusetts, Louisiana, Texas, California and Washington have developed their facilities and productivity in order to produce these tankers competitively.

Inland Dry Bulk Barges

Applications for $500 million--Additional inland dry bulk barges are necessary to support U.S. grain and coal transportation requirements for domestic and export markets. Inland dry bulk barge orders have increased to support trade requirements stimulated by America's increasing role as the world's leading supplier of agricultural products and coal. Efficient barge transportation to deepwater ports will be a major factor to increase U.S. export level and to support the conversion of mid-western utilities from imported oil to domestic coal. Shipyards in Louisiana, Missouri, Tennessee, Minnesota and Pennsylvania are leaders in U.S. inland barge construction.

Domestic Ocean Drybulk Vessels

Applications for $100 million--These constructions will support the conversion of Gulf Coast and northeastern utilities from imported residual fuel oil and natural gas to coal. Dry bulk vessel construction will begin to restore national domestic dry bulk capacity for coal transportation after almost 30 years. Shipyards along all three coasts and the Great Lakes are building ocean-going dry bulk barges.

Inland Towboats

Applications for $100 million--The towboats are necessary to propel the increased coal, grain and petrochemical traffic that will occur on the Mississippi River system and the Gulf Intracoastal Waterways. These towboats are designed to improve operating and fuel efficiency and must be built to service the barges that are required. Shipyards in Mississippi, Louisana, Alabama, Arkansas, Missouri, Minnesota, Tennessee and Pennsylvania are engaged in towboat construction.

National Defense Charters

Applications for $100 million--These petroleum product tankers are under construction for charter to the Military Sealift Command. Designed to be competitive in both commercial, military logistics and naval fleet auxiliary service, the ships are a direct response to the nation's need for world-standard, dependable petroleum products capabilities. These specific projects are only a portion of the U.S. fleet that is periodically chartered to service military logistics and Rapid Deployment Force Requirements. They are also capable of operating in non-military trades. Shipyards on all three coasts are capable of constructing ships of this type.

Dredges

Approvals of $45.8 million--Private sector construction of dredges is necessary to support the national requirement to increase and maintain the depth of U.S. harbors and to transfer a significant portion of the dredging operations from the Army Corps of Engineers fleet to the private sector. The dredging of harbors on all three coasts is a major requirement for U.S. competitiveness in coal and grain exports, and for the imports of key raw materials including ferrous and non-ferrous ores and energy products. The construction of dredges is conducted on all three coasts and in the inland waterways as far north as Minnesota.

RESTRICTIVE ANNUAL CEILINGS THREATEN 31,000 MAN-YEARS OF SHIPYARD EMPLOYMENT

The $675 million annual authorization ceiling, combined with the Maritime Administration's 75 percent guarantee level can finance $900 million of construction in FY1982. Assuming that a further $675 million (1981 dollars) will be made available in FY1983, some $1.8 billion of projects could be financed during FY1982 and FY1983. Because the October 1, 1981 active application backlog totaled $3.7 billion 1981 dollars, at least $1.9 billion cannot be financed during the next two years and is at risk.

This construction demand is placed at risk because the vessels can either be built overseas, postponed, or cancelled. Shipowners' decisions will rest upon the specific legal, financial and market conditions prevailing. Offshore equipment, which represents nearly one-half of the active Title XI backlog, is not subject to the Jones Act, and therefore can be constructed by foreign yards and operated by foreign crews. Besides the loss of U.S. shipyard employment, foreign exchange earnings are also jeopardized since many U.S.-built offshore rigs and supply vessels operate in foreign waters. The loss of Title XI eligibility will lead to placement of offshore orders overseas, due to more attractive financing terms than could be alternatively obtained in the U.S. (see Chapters IV and V).

The risk of postponement or cancellation of vessel orders which are reserved for U.S. shipyards is also very real. As detailed in Chapter IV, alternative financing methods available to the vast majority of U.S. vessel operators entail substantially greater short-run capital costs. These higher costs will affect the decision to proceed with a project, as they directly weaken vessel competitiveness and economic viability.

As shown in Exhibit III-2, the $1.9 billion of threatened projects exposes 31,350 man-years of shipyard employment. The Administration's decision not to guarantee offshore projects, combined with some additional projects, will impact severely on Gulf Coast shipyards (Alabama, Mississippi, Louisiana and Texas), exposing 26,400 jobs to possible loss and increasing the financial pressures on the independent operators to order equipment overseas. The Atlantic, Pacific, and inland regions will also be exposed to major job loss. Given that many small yards employ less than 500 persons, some shipyard closures are likely.

RESTRICTIVE CEILINGS DURING FY1982 AND FY1983 THREATEN 135,000 JOBS AND $8.9 BILLION TO THE ECONOMY

The $1.9 billion shortfall discussed above exposes more than one-half of the current projects to cancellations and overseas orders (see Exhibit III-3). The exposed shipbuilding activity is equivalent to:

- --31,350 man-years of shipbuilding employment and $600 million in wages (direct);
- --56,430 man-years of shipbuilding, material supplies and services employment and $1,100 million in wages (direct and indirect);
- --134,800 man-years of combined shipyard, indirect industry, and induced employment and $2.6 billion in wages (direct, indirect, and induced).

The total exposure to the economy of projects that cannot be guaranteed will be $8.9 billion, as Exhibit III-4 indicates.

CURRENT TITLE XI APPLICATIONS SEEK THE SERVICES OF SHIPYARDS NATIONWIDE

The current backlog of active applications totals $3.7 billion 1981 dollars. As Exhibit III-3 shows, the strong increase in offshore and river barge demand has increased the program's potential to stimulate Gulf and inland yards, but demand for the services for Atlantic, Pacific, and Great Lakes yards continues.

INCREASED TITLE XI FUNDING IS ALSO NECESSARY TO PRESERVE THE SHIPBUILDING BASE FOR COMMERCIAL AND MILITARY REQUIREMENTS

U.S. shipyards provide a vital service to U.S. shippers and vessel owners. The yards cannot artificially stimulate demand and must be able to respond competitively and in a timely fashion to preserve the productivity of the yards and to maintain the facilities and skilled labor forces necessary. The FY1982 Title XI ceiling cannot support the shipper, owner, and shipyard needs as it has since the creation of the program in 1938.

U.S. shipyards require sufficient Title XI funds during FY1982 and FY1983 to bridge a critical gap between the merchant marine programs, policies and markets of the 1970s and the 1980s. The 1980s are expected to be very different: Construction Differential Subsidy has been suspended and therefore a major source of deep-draft merchant ship demand has disappeared; naval construction is expected to increase in real terms, but the timing, types and awards of contracts are uncertain.

In the interim period, U.S. yards must be permitted to construct all types of vessels demanded by the marketplace. Title XI authorization should not be an obstacle to the orders placed by owners. The continued utilization of key U.S. yards to the maximum extent possible is essential until naval programs are implemented.

The exclusion of drilling rig construction poses a major threat to the independent operators that order this equipment and to the shipbuilding industry. Many major U.S. yards on all three coasts have the necessary experience, capability and commitment to build offshore equipment. The exclusion of this construction reduces the likelihood the operators will be able to order rigs in U.S. yards and will encourage orders to be placed abroad by foreign yards at the highly competitive and artificial financing terms of the Organization of Economic Cooperation and Development (OECD). These terms are discussed in detail in Chapter V.

The contribution of the Title XI program to the shipbuilding base and the merchant fleet's ability to support the military is significant. The fluctuating demands of naval shipbuilding programs on U.S. shipyards are offset by commercial activity. Title XI guarantees promote the design, contracting and construction of merchant vessels that complement naval construction. Without the Title XI program, reduced commercial activity would increase lay-offs and reduce the incentives to expand and maintain shipbuilding facilities and techniques. Shipyard utilization would decrease, overhead would increase and naval projects would incur higher costs. Manufacturers of marine equipment would also be affected. The role of Title XI in supporting all types of merchant ship construction is important because it helps to maintain employment and yard activity regionally and nationally.

The Title XI guaranteed fleet has also played a critical role in Military Sealift Command and Rapid Deployment Force capabilities. Roll-on/roll-off ships guaranteed by Title XI are currently key units in the Military Sealift Command's Near-Term Prepositioned Force.

Modern tankers built with Title XI are chartered to supply U.S. bases abroad with petroleum products, and are also pre-positioned with diesel fuel, jet fuel, and water. Two barge-carrying LASH ships built with Title XI guarantees were recently chartered by the Military Sealift Command.

TITLE XI SUPPORTS PRESIDENT REAGAN'S INDUSTRIAL INVESTMENT AND PRODUCTIVITY OBJECTIVES

As an effective no-cost program that facilitates private sector investment in capital-intensive long term capital assets, the Title XI program supports President Reagan's efforts to stimulate equity formation and facilitate the flow of capital into productive investments. The Title XI program is vital to the preservation of small and mid-sized owners' ability to participate in the industry, support efficient markets, and provide their management and operating expertise to shippers and other customers, including major corporations.

The Title XI program also supports the continued improvement of U.S. shipyard work force productivity, facilities and ability to compete for U.S. shipowners' contracts in the international marketplace. The ability to compete internationally is very important in the offshore sector.

THE TITLE XI PROGRAM MUST BE RESTORED TO SUPPORT THE NATION'S FUTURE NATIONAL MARITIME POLICY

The current backlog of active applications for Title XI guarantees is composed of many segments, each reflecting long-term opportunities and near-term market conditions. The $3.5 billion backlog of applications has been generated in a recessionary economic environment and despite high interest rates. Although the composition of demand will change in coming years, continued investment in productive and efficient ships to support the economy will occur. Great Lakes and coastal tank vessels are prime candidates for new construction. The Title XI program must be authorized to meet future demand.

It is also vital that the nation's shipbuilding base be maintained, pending the formulation of a long term national maritime policy. Title XI is the only major program that has demonstrated its ability to support new construction during this period. The shipbuilding defense base has been hard hit by the suspension of the Construction Differential Subsidy program. Title XI must be expanded to facilitate projects that seek to utilize U.S. yards in the intervening period. At no cost to the taxpayer, Title XI can contribute to future national maritime policy by preserving the shipbuilding capacity available today.

Exhibit III-1

COMPOSITION OF TITLE XI APPLICATIONS
September 31, 1981
(millions of dollars)

	Cost to Owner	Title XI Amount	Cost 1981 Dollars
---Domestic Service---			
Inland River Service			
Tank Barges	$36.1	$31.5	$39.3
Dry Bulk Barges	527.0	438.7	545.9
Towboats	78.0	60.6	82.4
Domestic Deepwater Ocean Service			
Liner Ships	8.5	7.4	9.4
Great Lakes	51.2	44.8	56.9
Tank--Ships, Barges & Tugs	826.2	723.1	907.9
Drybulk—Ships, Barges & Tugs	96.6	78.2	97.4
National Defense Services	54.0	40.5	59.9
Passenger Ships	95.1	80.0	105.6
Miscellaneous			
Dredges	45.8	35.7	49.0
Harbor Craft	60.7	50.5	65.0
Drydocks	—	—	—
Subtotal	1,879.2	1,591.0	2,018.7
Offshore Service			
Offshore Rigs & Support Craft	1,608.9	1,209.2	1,688.2
TOTAL	3,488.1	2,800.2	3,706.9

NOTE: Excludes applications for foreign trading vessels with a total cost to owner of $1.4 billion due to suspension of the CDS program.

Source: TBS analysis of MarAd Active Applications, September 30, 1981.

Exhibit III-2

REGIONAL IMPACT ON SHIPYARD EMPLOYMENT
IF TITLE XI GUARANTEES HELD AT $675 MILLION
ANNUAL AUTHORIZATION CEILING

(billions of constant 1981 dollars)

	October 1, 1981 Project Value Applications	Projected FY1982 and FY1983 Projects With $675mm Annual Authorization	Threatened Projects	Lost Shipyard Employment Man-Years
Atlantic	$0.5	$0.4	$0.1	1,650
Gulf	2.1	0.5	1.6	26,400
Inland	0.5	0.4	0.1	1,650
Pacific	0.5	0.4	0.1	1,650
Great Lakes	0.1	0.1	—	--
Total	$3.7	$1.8	$1.9	31,350

NOTE: Reductions based primarily on elimination of offshore projects as stipulated by the Administration.

Exhibit III-3

REGIONAL DISTRIBUTION OF PENDING APPLICATIONS
AS OF END FY1981

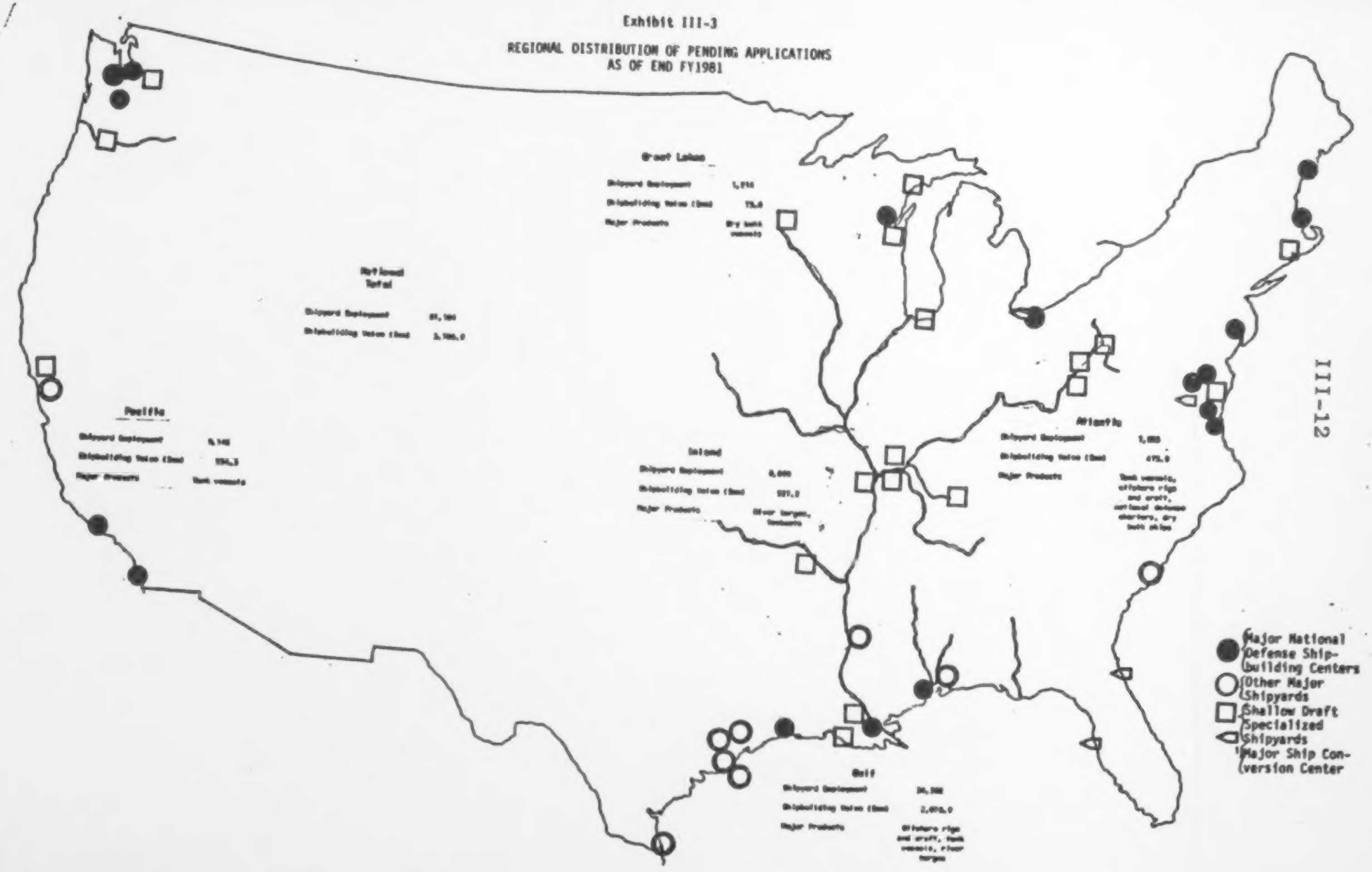

Great Lakes
Shipyard Employment 1,214
Shipbuilding Value ($mm) 73.4
Major Products Dry bulk vessels
National Total
Shipyard Employment [illegible]
Shipbuilding Value ($mm) [illegible]
Pacific
Shipyard Employment [illegible]
Shipbuilding Value ($mm) 154.3
Major Products Tank vessels
Inland
Shipyard Employment [illegible]
Shipbuilding Value ($mm) 597.2
Major Products River barges, towboats
Atlantic
Shipyard Employment [illegible]
Shipbuilding Value ($mm) 475.0
Major Products Tank vessels, offshore rigs and craft, national defense charters, dry bulk ships
Gulf
Shipyard Employment [illegible]
Shipbuilding Value ($mm) [illegible]
Major Products Offshore rigs and craft, tank vessels, river barges
● Major National Defense Shipbuilding Centers
○ Other Major Shipyards
☐ Shallow Draft Specialized Shipyards
◁ Major Ship Conversion Center

Exhibit III-4

ECONOMIC IMPACT OF CURRENT TITLE XI CEILINGS
FY1982 and FY1983

(1981 dollars)

	Market Demand	Arbitrary Ceilings	Value Foregone
Guarantee Amount (billions)	$3.2	$1.35	$1.85
Value of Vessels (billions)	3.7	1.8	1.9
Employment (man-years)	61,050	29,700	31,350
Payroll, ($ billions)	1.2	0.6	0.6
----Interindustry Impact---- (Direct plus Indirect)			
Revenues ($ billions)	$7.4	$3.6	$3.8
Employment (man-years)	109,890	53,460	56,430
Payroll ($ billions)	2.2	1.1	1.1
----Overall Impact on the Economy---- (Direct, Indirect, plus Induced)			
Revenues ($ billions)	$17.4	$8.5	$8.9
Employment (man-years)	262,515	127,710	134,805
Payroll ($ billions)	5.2	2.6	2.6

Point: Show how much revenue, employment, and wages will potentially be lost due to the administrative ceiling of $675 million per year for next 2 years.

IV. IMPACT OF ALTERNATIVE FINANCING METHODS

The Title XI guarantee permits vessel owners to obtain financing of a type and on terms that they often could not obtain otherwise. There is a very substantial difference in the cash flows of financings with Title XI and those secured by alternative methods. The difference is great enough to make some investments noncompetitive, causing them to be postponed or cancelled. For vessels which can be built abroad--all vessels except those in the domestic trades--inability to secure Title XI will cause some owners to order vessels overseas. Loss of U.S. construction contracts reduces production in U.S. shipyards, decreases the indirect and induced spending, wages, and employment benefits described in Chapter II; and results in higher transportation costs for vessels which are financed on less favorable terms, or provided by less efficient ships that remain in service.

Smaller independent vessel and barge operators suffer greater financing difficulties than large corporations when Title XI guarantees are restricted. This is because of the limited access by smaller operators to favorable alternative financing methods. Guarantee limitations--such as those imposed in FY1982--are especially hard on the competent, independent operators who lack major financial resources. Title XI has tended to be utilized by small and mid-size companies. Large companies can obtain financing on their own credit at Aaa rates, or use internal sources of funds. They tend not to seek Title XI guarantees, which would result in more costly financing when the annual guarantee fees are considered.

For some ship and barge operators, there is virtually no alternative. If Title XI were not available, they would be shut out of the market.

TITLE XI BONDHOLDERS AND SHIPOWNERS PROVIDE THE CAPITAL FOR ALL PROJECTS

Bonds issued with Government guarantee under Title XI--often referred to as Title XI bonds--are essentially corporate sinking fund bonds, with a fixed rate of interest and a long-term maturity, guaranteed by the U.S. Government. Generally, the guarantee covers 87.5 percent of the actual cost of construction, although vessels receiving construction-differential subsidies are limited to 75 percent. In addition to the equity portion of the vessel's capital cost, the Maritime Administration requires that the owner maintain an appropriate reserve fund for working capital throughout the life of the guarantee and that the owner provide funds for the cost of foreign-built equipment that could have been purchased from U.S. manufacturers.

All new commitments during FY1982 are being issued at the 75 percent level to increase the distribution of the limited commitment authority. The remaining 25 percent (previously 12.5 percent for non-subsidized projects) of the construction cost is supplied by the owner as equity participation. In many transactions, the vessel operator--barge line, steamship company, drilling rig operator--owns the vessel directly, supplying the equity himself; the guaranteed portion is then placed privately, through an investment banker, with an institution. In other cases, the owner is a leasing company, limited partnership, or other entity that provides the equity, and the vessel is then leased to the operator by the owner or managed by the operator on a fee basis. The term of the loan is generally from 15 to 25 years, depending upon economic considerations and the operating life of the vessel. The loan normally provides for equal repayments of principal semi-annually; thus, the average life of a 25-year bond is about 12.75 years.

THE TITLE XI PROGRAM PERMITS OPERATORS TO SECURE FUNDS WITH AN EFFECTIVE A-RATING

The interest rates for Title XI bonds are generally similar to prevailing levels for Aa long-term corporate bonds, and consistently exceed the 20-year Treasury Bond rate. Once the investment banker has secured commitments for the full amount of the Title XI bond, the final interest rate must be approved as "fair and reasonable" by the Maritime Administration. The market rate on actively-traded U.S. Treasury bonds of similar maturity is utilized as a pricing benchmark, and the size of the spread is often similar to that of an Aa rated corporate bond. The spread varies, generally narrowing as interest rates fall and widening with higher rates. At times, a Title XI bond can command an interest rate as low as that on a Aaa-rated bond, while at other times the interest must be set as high as an A-rated corporate bond to place the debt. The interest rate may also be higher in the case of a small offering. With the addition of the annual Title XI guarantee fee of between 1/2 percent and 1 percent (paid to the Maritime Administration's Federal Ship Financing Fund), the effective cost to the borrower approaches that of an A-rated corporate bond. Spreads of Title XI new issues have ranged from 50 to 190 basis points (0.5 to 1.90 percentage points) above the corresponding Treasury bond during 1981 (see Exhibit IV-1).

TITLE XI BONDS ARE ATTRACTIVE TO INVESTORS

The market for Title XI bonds consists largely of institutional buyers, such as pension funds and insurance companies. Title XI bonds are attractive because they are guaranteed by the Government yet carry higher yields than standard Treasury issues. Title XI bonds can sometimes be sold with lower interest rates than certain other Government-guaranteed bonds, such as GNMA mortgage certificates, because the Title XI bonds have a longer average life and a more predictable repayment schedule due to the sinking fund. This allows fund managers to more closely match inflows with actuarial projections of funds requirements. The Maritime Administration's approval of the interest rate is useful to pension fund managers as a confirmation of reasonableness. Finally, a modest secondary market in Title XI bonds exists reflecting investors' interest and appreciation of the Title XI program.

Title XI bonds are a favorable method for owners or operators to raise funds for the purchase of vessels, and simultaneously enjoy a respected position in financial markets. Terms and access are summarized below:

Maturity:	15-25 years, depending upon economic considerations and the operating life of the vessel.
Interest Rate:	Fixed, equivalent to Aa corporate bond. The guarantee fee increases the effective rate to an A-rated corporate bond level.
Equity Required:	12.5-25.0 percent as equity for the vessel, plus working capital as

	required by the Maritime Administration, and the cost of any foreign parts which could have been obtained in the U.S.
Security:	Title XI Guarantee (a contingent liability of the Federal Government), backed by a first preferred ship mortgage.
Access:	Available to small and large owners, based on adequate net worth and working capital. Projects approved after strenuous review process by Maritime Administration.
Market:	Excellent among institutional investors.

ALTERNATIVE FINANCIAL SOURCES CANNOT SUPPORT THE BROAD RANGE OF MARINE FINANCING THAT TITLE XI SERVES

Among the many possible methods of financing marine equipment, four possibilities are the most common: commercial bank loans, placement with long-term institutional lenders, leasing, and finance companies. Although these sources attempt to serve the marine market as part of their industrial activity, very few institutions can deal effectively with the risk characteristics and the long-term financing requirements that are typical of the marine industry. It is also difficult for banks to provide the marine specialists and independent analytic capabilities necessary to evaluate projects and provide terms competitive with Title XI. This situation results in higher interest rates and shorter terms, and seriously reduces the ability of owners to secure financing for modern vessels.

The alternative sources also tend to emphasize long-term life-cycle charters or cargo commitments. Because many markets cannot provide long-term contracts, these preferences can be offered by very few independent operators. Therefore many non-Title XI loans are related to dedicated or private cargo carriage which comprises only a portion of the total demand for marine financing.

Title XI plays a vital role in meeting the needs of more dynamic, market-intensive shipping segments, where independent owner/operators actively support shippers and their logistics and energy development needs. The program also serves as the most intensive and sophisticated marine financial analysis resource, and the great majority of institutions look to approved projects as a benchmark for economically sound proposals.

Commercial Banks Tend to Provide Short-Term, High Interest, Floating Rate Loans with Substantial Equity Requirements

Commercial banks lend for vessel construction, but strictly on a short-term basis (five to ten years) and with a floating rate of interest. The overall terms depend on the creditworthiness of the vessel owner, operator, or charterer. Access by smaller marine firms--typically barge operators, tug/supply vessel operators, and small deepsea ship operators--to bank credit is not necessarily certain, at any interest rate. Typical terms are:

Maturity:	5-10 years
Interest Rate:	Floating, prime plus 1/2 - 3 percent
Equity Required:	25-50 percent of vessel cost
Security:	Assignment of time charter, mortgage on vessel or fleet, personal guarantees.
Access:	Depends on credit analysis.
Market:	Commercial banks.

Private Placement with Long-Term, Institutional Lenders is Available Only to the Largest Corporations

Large corporations are able to place long-term bonds directly with institutions such as pension funds, but this type of fixed-rate, long-term financing is rare today, and the issuer would have to be an extremely substantial organization with a Aaa rating. The pension funds seek the most secure issuers for long-term bonds, and are not interested in assessing the risk of a medium-sized or unknown company. In the marine industry, the major oil companies are among the few who could obtain funds in this manner. They tend not to seek Title XI guarantees, since their credit standing enables them to obtain lower rates by selling bonds on their own. Independent operators generally cannot execute private placements. For the few firms eligible, the terms are:

Maturity: 12-15 years

Interest Rate: Fixed, generally comparable to Aaa or Aa-rated industrial bonds.

Equity Required: 25-50 percent of vessel cost

Security: Assignment of charter hire, ship mortgage.

Access: Limited to major corporations

Market: Institutional investors.

Leasing Is Also Geared Towards Major Projects; Many Smaller Operators Cannot Secure Leases

Leasing also generally requires a strong credit rating. Leveraged leases--often used for costly items of marine equipment--involve the lessor providing equity of some 35-45 percent, with the balance in long-term debt, if it can be obtained. A leveraged lease is generally not arranged for low-cost vessels, due to the complexity involved in setting up the transaction. In a lease situation, the ship operator passes the tax benefits to a lessor in exchange for a lower effective interest rate. Most marine leasing has been performed in conjunction with a Title XI guarantee. A long-term lease would require the same credit standing as noted earlier for a long-term bond placement.

Maturity: 10-20 years

Interest Rate: Depending on tax considerations, the implicit interest rate can be 350 to 500 basis points (3.5 to 5.0 percentage points) below the equivalent bond rate.

Equity Required: Lessee provides no equity. Lessor provides 35-45 percent equity for a

	leveraged lease, or 100 percent for a direct lease.
Security:	Assignment of charter hire.
Access:	Without Title XI guarantee, limited to major corporations.
Market:	Leasing companies.

Finance Companies

These organizations (e.g., General Electric Credit Corporation, General Motors Credit Corporation, etc.) offer loans and leases. Finance companies can provide funds for a somewhat longer term than banks, but interest rates are high due to the higher perceived risk often associated with typical projects. These projects may be higher risks, as a group, than those financed by commercial banks. Typical terms are:

Maturity:	3-15 years
Interest Rate:	Generally, prime plus 3-4 percent. Fixed rate funds, if available, would cost about 18 percent with a maximum term of 7 to 10 years.
Equity Required:	30-50 percent.
Security:	Mortgage
Access:	Depends on credit standing.
Market:	Finance companies.

ALTERNATIVE FINANCING METHODS CAN HAVE A MAJOR IMPACT ON PROJECT VIABILITY

Alternative financing methods can have a substantial impact on the capital charges associated with the acquisition of a new vessel. Because capital charges (amortization plus interest) for modern marine equipment can amount to as much as 75 percent of total annual costs (capital charges, fixed operating, and voyage costs), the financing terms available strongly influence the viability of a proposed investment.

The financing methods described above differ in terms of interest rate, repayment period, equity portion required, security needed, and whether the interest rate is fixed or floating.

The impact differential on capital charges between financing with a Title XI guarantee and under an alternate method varies a great deal. One of the major alternatives for a small or medium-sized firm, however, is likely to be a commercial bank or finance company loan, for a period of five to eight years with interest floating at a rate based upon the prime rate.

The Title XI Program Results in Significant Cash Flow Improvements When Compared to Conventional Bank Loans

In order to illustrate the immediate, near- and long-term advantages of the Title XI program, three typical financing alternatives are evaluated below. The three alternatives are:

	Type	Term	Interest Rate	Equity Required
1.	Bank loan	7 years	17.0%	50%
2.	Title XI bond	25 years	15.0%	25%[1]
3.	Title XI bond	25 years	15.0%	12.5%[1]

These alternatives were selected to approximate major shipowner options in the financial markets. For the bank loan, a rate of prime plus 1-1/4 percent has been assumed (with the prime rate at 15-3/4 as of early January 1982, and assumed to continue at that level). The high equity requirement is typical of a situation where long- term charters are not normally available, as is the case for harbor tugs, inland towboats and river barges, offshore rigs and supply craft. One barge financing executed in 1981 without Title XI, for instance, required 55 percent equity, a floating interest rate at prime plus 2 percent, and a five- year term. Interest rates on non-Title XI guaranteed drilling rig projects have recently been as high as 18 percent. For the Title XI bond financing, an interest rate of 14.50 percent plus 0.50 percent annual guarantee fee has been assumed, consistent with recent

---

[1] In addition to this equity for the capital outlay, the Maritime Administration requires that a stipulated amount of working capital be maintained during the life of the vessel.

Title XI financings. The impact on cash flow of the equity requirement is tested by assuming two typical levels of guarantee.

Cash outflows relating to the equity and debt portions of the vessel cost have been computed for the bank loan and Title XI bond alternatives. For ease of calculation, level payments of principal plus interest are assumed, on a semi-annual basis, and all figures are pre-tax or assume a zero-tax situation. The results depend very much on the time horizon selected, as shown in Table IV-1.

Table IV-1

NET PRESENT VALUE OF CASH OUTFLOWS
(15 percent discount rate)

Alternative	Initially (Equity)	Over the First Five Years	Over the Life of the Loan/Bond
1. Bank loan	100.0	100.0	100.0
2. Title XI, 25% equity	25.0	69.7	97.1
3. Title XI, 12.5% equity	12.5	63.3	97.1

During the critical early years of operation of a new item of marine equipment, the capital costs are substantially lower when financed with Title XI-guaranteed bonds. Over the first five years, the discounted cash flows required by the initial equity and by debt repayments under Title XI bonds are 60-70 percent of the equivalent cash outflow with a bank loan. For a $40 million vessel cost, this difference in discounted cash outflows over the first five years amounts to between $13 and $14 million. At a 20 percent discount rate, the Title XI bond (12.5 percent equity) is only 61 percent of the bank loan cash outflow over the first five years, and 83 percent over the life of the bond (see Exhibit IV-2). The Title XI guarantee with 12.5 percent equity has been suspended thus far in FY1982 due to the annual authorization ceiling that was imposed by the Administration.

TITLE XI PROVIDES COMPETENT INDEPENDENT OPERATORS WITH ACCESS TO CAPITAL

The relative benefits to a vessel owner of the Title XI guarantee vary, depending on the financing alternatives which are available. Numerous types of financing schemes have been developed, including variations on the major categories discussed earlier. The new leasing laws may give rise to further creative possibilities, but smaller firms qualify for few of these alternatives. By financial standards, many U.S. vessel, barge, and offshore owners or operators are very limited in their financing alternatives. The Title XI program thus provides them with an important source of funds.

The degree of benefit can be characterized as follows:

- For a select few large corporations, there is no direct advantage in obtaining a Title XI guarantee. The financial terms (including the annual guarantee fee) would be less attractive than offering their own corporate bonds to institutional investors, or funding marine projects from internally generated funds. Very few major corporations seek Title XI financing.

- For a wide range of owners of U.S.- flag vessels, inland tugs and barges, and offshore oil rigs and supply vessels, Title XI permits owners to construct efficient and economically sound equipment on reasonable terms. This supports the nation's need for efficient vessels. Without Title XI, using a commercial bank term loan, a company would acquire funds at a cost that is typically 35-40 percent more during the critical first five years. Title XI costs are reasonable due to the favorable differential in interest rates, the much longer maturity obtainable with the guarantee (which approximates the vessel's economic life), and the lower equity requirement.

- For many vessel owners, Title XI represents the only viable source of funds. This group includes independent, small and mid-size firms, that possess the necessary experience and management competence but lack the financial strength to obtain favorable credit terms from commercial lenders without the guarantee of the Government or a major corporation.

THE CURRENT RESTRICTIONS ON TITLE XI FUNDING AUTHORITY DISRUPT DECISIONS FOR NEW CONSTRUCTION AND HAMPER SHIPPER AND SHIPBUILDING ACTIVITY

For the broad range of medium credit-risk marine companies, the difference betwen Title XI and conventional sources is substantial enough to reverse decisions to construct new vessels. By restricting the types of vessels eligible and the annual level of Title XI commitments available, the demand for vessel and oil rig construction will be artificially and unnecessarily restricted, at a time when U.S. cargo and offshore markets and the shipbuilding industry require new construction. Vessel orders will be postponed or cancelled, and orders for non-coastwise (foreign-trading) services will likely be placed abroad. This represents a particular threat to the offshore drilling rig construction market, since these vessels are not required to be built in the U.S. The rapid expansion of overseas construction of drilling rigs coincides with the imposition of restrictions on the availability of Title XI guarantees for these projects.

Exhibit IV-1

COMPARISON OF INTEREST RATES ON TITLE XI BONDS WITH THOSE ON U.S. TREASURY AND CORPORATE BONDS

Date (month)		Treasury Bonds (20 year term)	Title XI New Issues Over 10 years (monthly range)	Aaa Corporate Bonds	Aa Corporate Bonds	A Corporate Bonds	Public Utilities
1981	December						
	November		14.15-15.35				
	October	15.13	16.00-16.30	15.40	15.82	16.47	
	September	15.07	15.875-16.85	15.49	15.95	16.36	
	August	14.52	16.45	14.89	15.42	15.76	
	July	13.92	14.875-15.50	14.38	14.79	15.36	15.87
	June	13.20	14.45-14.80	13.75	14.41	15.08	15.27
	May	13.82	14.50-15.20	14.32	14.88	15.43	15.84
	April	13.46	13.90-14.95	13.88	14.39	14.82	15.32
	March	12.94	13.40-14.125	13.33	13.90	14.47	14.86
	February	12.98	13.75-14.25	13.35	13.89	14.27	14.84
	January	12.29	13.50	12.81	13.52	13.83	14.22
1980	December	12.49	13.30	13.21	13.78	14.03	14.48
	November	12.44	13.45-13.50	12.97	13.34	13.59	14.07
	October	11.75	12.25-13.00	12.31	12.68	13.05	13.53
	September	11.47	12.00-12.60	12.02	12.52	12.97	13.29
	August	11.07	11.55-12.00	11.64	12.09	12.44	12.82
	July	10.32	10.95-11.30	11.07	11.43	11.95	12.12
	June	9.89	10.40-10.75	10.58	11.39	11.89	11.87
	May	10.44	11.00-11.50	10.99	11.91	12.35	12.17
	April	11.42	11.75-11.90	12.04	13.06	13.55	13.50
	March	12.49	none issued	12.96	13.51	13.97	14.33
	February	12.21	12.75-14.00	12.38	12.73	12.99	13.48
	January	10.65	11.25-11.75	11.09	11.56	11.88	12.12
1979	December	10.18	11.10-11.35	10.74	11.15	11.46	11.68
	November	10.37	10.95-11.35	10.76	11.22	11.50	11.73
	October	9.99	10.4-11.0	10.13	10.46	10.83	11.13
	September	9.21	11.5	9.44	9.70	10.03	10.19
	August	8.97	9.35	9.23	9.53	9.85	9.97
	July	8.92	9.15-9.40	9.20	9.49	9.75	9.90
	June	8.91	9.25-9.50	9.29	9.66	9.89	10.04
	May	9.21	9.65-9.75	9.50	9.86	10.00	10.23
	April	9.12	none issued	9.38	9.65	9.88	10.05
	March	9.08	9.40-9.45	9.37	9.61	9.81	10.02
	February	9.03	none issued	9.26	9.50	9.68	9.84
	January	8.98	none issued	9.25	9.48	9.72	9.85
1978	December	8.90	9.25	9.16	9.33	9.53	9.67
	November	8.75	9.20-9.30	9.03	9.24	9.48	9.58

Note: Data on U.S. Treasury bonds, corporate and public utility bonds are monthly averages of yields on traded securities compiled by the U.S. Treasury and by Moody's Investors Service. The Title XI rates refer to new issues floated during the period.

Source: TBS Analysis of Federal Reserve Bulletin; Survey of Current Business; Maritime Administration data.

Exhibit IV-2

RELATIVE IMPACT OF FINANCING TERMS

Alternative	A	B	C
Type:	Bank term loan	Title XI bond	Title XI bond
Repayment:	Equal P + I	Equal P + I	Equal P + I
Frequency:	Semi-annual	Semi-annual	Semi-annual
Interest Rate:	17.0% p.a.	15.0% p.a.	15.0% p.a.
Maturity:	7 years	25 years	25 years
Vessel Cost:	$40 million	$40 million	$40 million
Equity:	$20 million	$10 million	$5 million
Debt:	$20 million	$30 million	$35 million
Discount Rate = 20% p.a. ($ millions)			
Semi-annual Cash Outflow	2.497	2.312	2.698
NPV, first 5 years	35.34	24.21	21.58
NPV, total loan/ bond life	38.39	32.92	31.75
Discount Rate = 15% p.a. ($ millions)			
Semi-annual Cash Outflow	2.497	2.312	2.698
NPV, first 5 years	37.14	25.87	23.52
NPV, total loan/ bond life	41.18	40.00	40.00

Notes: 1. NPV includes the initial cash outflows of the equity required, plus the discounted value of loan or bond repayments.

2. Taxes are not considered.

Source: TBS analysis.

V. COMPARISON OF TITLE XI WITH OTHER U.S. AND FOREIGN FINANCING PROGRAMS

As a non-subsidized self-funded guarantee program, Title XI compares favorably with many much larger U.S. Government loan guarantee and insurance programs. Interest rates are entirely set by financial markets, independent of government influence. The Title XI program incurs no interest rate subsidies, in contrast to the extensive export credit subsidy programs provided by virtually every foreign shipbuilding nation. At no cost to taxpayers, the Title XI program offers an important competitive inducement to build vessels in the U.S. rather than at overseas shipyards.

TITLE XI RATES ARE MARKET-BASED

The Title X1 program is unusual among federal loan guarantee and insurance programs because the interest rates are set in the marketplace. Although the Maritime Administration approves the interest rate as fair and reasonable at the time of issuing the debt security, the rate is actually determined in the marketplace once the investment banker has circulated the offering. Interest rates on Title XI mortgage bonds issued in the past six months have ranged from 14 to 17 percent, compared to the highly subsidized rates on loans guaranteed under other federal programs, some of which provide substantial subsidies of interest rates (see Exhibit V-1).

MOST MAJOR FEDERAL PROGRAMS OFFER SIGNIFICANT SUBSIDIES; TITLE XI DOES NOT

The Title XI program is a commercial loan guarantee program, and assists shipowners in receiving mortgages at reasonable interest rates, established in the financial marketplace. In comparison to many larger federal programs, the experience of the Title XI program has been far less costly. Thus far the program has incurred no net cost in operations or guarantees to the federal government. The programs listed below provide capital to industry at interest rates only one-third to one-half the prevailing market and Title XI program rates:

- Export-Import Bank, medium term guarantees--6-8 percent.
- Rural Electrification Administration, electrical systems guarantees--2-5 percent.
- General Services Administration, Federal building fund--4.67-8.2 percent.
- Farmers Home Administration, water and waste disposal loans--5 percent.

TITLE XI GUARANTEES ARE LESS THAN 2 PERCENT OF FEDERAL AGENCY LOANS, GUARANTEES AND INSURANCE

The volume of Title XI guarantees outstanding represents a very small and declining proportion of total direct loans, loan guarantees and insurance outstanding by federal agencies. As of September 30, 1981, Title XI guarantees represented $6.6 billion out of the $570 billion total federal direct and guaranteed loans outstanding, 1.2 percent of the total (see Exhibit V-2). This percentage has declined recently, with the average Title XI proportion for FY1980 and FY1981 only 82 percent as high as during FY1976-FY1979. Some $211 billion of federal credit programs outstanding (out of the $570 billion total) consists of direct loans or credits, about half of which are handled through the Federal Financing Bank. Title XI bonds are not handled by the Federal Financing Bank, as the funds are obtained directly in the private capital markets by shipowners and their investment bankers.

THE TITLE XI PROGRAM DOES NOT DISTORT CAPITAL MARKETS

The Title XI guarantee program does not distort the allocation of credit in U.S. capital markets. Title XI interest rates are set by the market, and tend to secure rates equivalent to those of Aa-rating corporate bonds. The same rating level and interest rates would presumably be obtained if the Title XI program were conducted by a private corporation with financial resources equivalent to those of the Government. The fact that there has been no net cost to the

Government over the life of the program indicates that it has been conducted on an economically sound basis. The program is also not distortionary because the volume of Title XI net annual new commitments is so small compared to the volume of net new funds made available through the U.S. credit markets. As shown in Exhibit V-3, net additional Title XI contracts in force (new commitments less repayments of guaranteed principal) have averaged annually about one five-hundredth of total net credit funds raised over the past 12 years. Title XI net new guarantees have declined as a proportion of total net funds raised in U.S. credit markets, from 0.30 percent over the 1971-1976 period to 0.12 percent during the 1977-1982 period.

Long-term financing available with the Title XI guarantee makes economic sense and taps the unique capabilities of the U.S. capital markets. The economic lifetimes of most marine vessels range from 20 to 30 years and financing over the same period thus is appropriate, provided that the loan is amortized to reflect depreciation of the asset value. The Title XI program complements the long-term revenue-generating qualities of marine equipment by providing owners access to long-term financial resources. The positive reaction of the private capital markets reflects confidence in the Government's close scrutiny of applications, its insistence on first preferred mortgages with detailed covenants, the spreading of risk through creation of a portfolio, charging fees that fully recover costs, and the ability to invoke the Treasury's resources as the ultimate resort. Title XI thus represents a positive and creative utilization of the capital markets.

TITLE XI COMPARED WITH FOREIGN SHIPBUILDING PROGRAMS

In contrast to the market-based interest rates that the Title XI extends to domestic shipowners, foreign government intervention in the financing of merchant ships, both for export and for domestic service, is standard practice. Internationally, financing assistance is considered the mildest form of assistance to the vital shipbuilding industry, when compared to the various forms of direct payments to the shipyards to subsidize the cost of ships. Favorable credit terms for shipbuilding are so commonplace that the Organization for Economic Development and Cooperation (OECD) has developed an international agreement that attempts to limit and standardize the degree of financial concessions offered by shipyards in the highly competitive international shipbuilding marketplace. Many governments offer credit schemes to domestic owners for ships built domestically, generally on terms even more favorable than those available for export contracts.

The OECD credit terms have evolved in line with the general trends in the member countries, and currently are as follows:

Minimum net interest:	8 percent per annum
Minimum down payment:	20 percent
Maximum repayment period:	8.5 years.

Belgium, Canada, Denmark, Finland, France, Great Britain, the Netherlands, Italy, Japan, Norway, Spain (until March, 1979), Sweden and West Germany are signatories to these terms. The United States is not a party to the agreement and does not offer credit at these subsidized terms. If a non-OECD country offers better export credit terms than the general rule, the member countries are allowed to offer equally competitive terms after having notified the other member countries. The general rules do not cover domestic orders and credits.

FOREIGN DOMESTIC SHIP FINANCING PROGRAMS ARE HIGHLY SUBSIDIZED

Ships built in European shipyards for domestic owners are often the object of very favorable credit terms. In Belgium, new ships for domestic owners can be financed at 1 percent interest over 15 years, with a two to three year moratorium on interest and principal, for 80 percent of the vessel cost. An additional 10 percent of the contract price is subsidized by loans at 5 percent interest over 15 years. The West German government offers financing at 2 percent below the market rate, with 12-year repayment, on 90 percent of the contract price. These financing schemes are in addition to various forms of direct assistance to the shipyards and ship operators in these countries. Spain notified the OECD in March 1979 that it was withdrawing from the "Understanding on Export Credits for Ships" in order to be able to offer more favorable terms to foreign shipowners. In late 1979 a Spanish shipyard signed a contract with Polish Ocean Lines to build four large containerships. A 15 percent subsidy reduced the total price to $200 million; 85 percent of the principal was financed at 8 percent interest over 8.5 years, with the remaining 15 percent of principal at rates from 4 percent to 6.5 percent with repayment over 13-15 years.

TITLE XI MEETS DEVELOPING FOREIGN COMPETITION AND PRESERVES U.S. LEADERSHIP IN KEY SECTORS

Developing nations also offer attractive financing terms to secure needed orders. Brazil offers options of 90 percent, 85 percent and 70 percent financing repayable over 10, 12 and 15 years respectively, all at 7 percent interest. Domestic owners can obtain government financing at 5 percent interest over 15 years, for 85 percent of contract value. South Korea's willingness to provide export credit denominated in U.S. dollars has provided it with an important competitive advantage over Japan, whose credits are extended in Japanese yen. Korea's export credit typically covers 75-85 percent of the contract price, repayable over 5-10 years at 7-8 percent interest. Domestic Korean owners can obtain 90 percent credit over 8 years, at 1 percent interest and with a two year grace period.

The Title XI Program is a vital bulwark against the stiff price competition of certain developing nations that seek to license U.S. technologies, and serve the offshore drilling rig and supply vessel markets. Taiwan, Korea, China, and Singapore are offering highly attractive financing to lure offshore equipment purchasers away from U.S. yards. Title XI is a vital vehicle to resist these pressures--at no cost to the Federal budget and the taxpaying public.

Over the long-term, U.S. leadership in ocean drilling and servicing technology will be dependent upon the retention of the cost-competitive, technically-advanced national industrial base. In addition to shipyards, the drilling equipment suppliers that provide key technologies for drilling, pipe handling, drill cement and mud handling, propulsion, moving and control systems benefit directly from Title XI.

TITLE XI PROGRAM HELPS TO KEEP U.S.-FLAG VESSELS IN U.S. YARDS AT NO COST TO THE GOVERNMENT

The Title XI program is a major factor in retaining shipbuilding orders in the U.S. for equipment that could also be built abroad. This particularly affects offshore drilling rigs and vessels, high technology ocean-ships and reconstruction. For example, a drilling rig would be built in the Far East for a somewhat lower price than in the U.S. but this price advantage is offset by the towing costs to bring the rig from the Far East to the Gulf of Mexico, and by the advantageous Title XI financing. When typical Title XI financing is compared with OECD standard terms, the discounted cash flow over the first five years (at a 15 percent discount rate) is 44 percent less with Title XI, as shown in Exhibit V-4. Title XI guarantees can thus make a critical difference in the decision whether to build at home or abroad, without incurring any cost to the U.S.

THE TITLE XI PROGRAM WILL CONTINUE TO BE A MAJOR INCENTIVE TO BUY AMERICAN

Despite efforts over many years by the OECD and the EEC to reduce subsidies to the shipbuilding industry in member countries, substantial direct subsidies in the form of reduced interest rates persist. A recent estimate of subsidies paid annually to the shipbuilding industry of Western Europe is some D.M. 726 million (about $1.5 billion). Although the Title XI program costs the taxpayers nothing, it provides an important competitive incentive to U.S. vessel owners to order those vessels which could be built either in the U.S. or abroad from U.S. shipyards. The importance of the Title XI program as a means to preserve U.S. shipbuilding has been increased by the decision to allow foreign construction of U.S.-flag vessels intended to receive operating differential subsidy contracts. The strength of Title XI is its ability to tap long-term funding sources rather than relying on interest rate subsidies. The U.S. taxpayer, shipbuilding base, shipowner, and shipper are all well-served by the Title XI program.

Exhibit V-2

TITLE XI GUARANTEES OUTSTANDING AS A PROPORTION OF FEDERAL DIRECT, GUARANTEED AND INSURED LOANS OUTSTANDING

1976-1981

($ millions)

Year (as of Sept. 30)	Title XI Program Guarantees Outstanding	Total Loans, Guarantees and Insurance Outstanding by Federal Agencies	Title XI as % of Total
1976	3,590.5	299,195.5	1.2
1977	4,716.8	327,122.4	1.4
1978	5,167.8	371,339.7	1.4
1979	5,438.5	427,313.1	1.3
1980	5,932.7	576,353.7	1.0
1981	6,567.7	569,757.7	1.2
Six Year Average:			1.25

NOTE: Title XI figures are not identical to the Maritime Administration's contracts in force data, as the latter include commitments made but not exercised by the applicants.

Source: TBS analysis of Treasury Bulletin data.

Exhibit V-1

COMPARISON OF TITLE XI WITH SELECTED FEDERAL GUARANTEE PROGRAMS
(as of September 30, 1981)

Program	Amount Outstanding ($ millions)	Government Fee or Premium (%)	Interest Range (%)
Maritime Administration:			
Title XI Program	6,568	1/2 - 1%	Market Determined
Export-Import Bank:			
Medium-Term Guarantees	3,075	1/2 - 1-1/2%	6 - 8%
Small Business Administration:			
Business Loans	7,728	1/4%	9-1/4%
Veterans Administration:			
Guaranteed Mortgages	46,991	-	3 - 9-1/2%
Housing & Urban Development Department:			
Mortgage Insurance Loans	131,106	0 - 1/2%	3 - 13%
Farmers Home Administration:			
Water and Waste Disposal Loans	4,741	Variable	5%
Farm Enterprise Ownership Loans	5,126	Variable	5 - 13.25%
Treasury Department:			
Chrysler Corp. Loan Guarantee	1,200	-	10.35 - 11.40%
General Services Administration:			
Federal Building Fund	1,245	-	4.67 - 8.2%
Rural Electrification Administration:			
Electrical Systems	15,045	-	2 - 5%

Source: U.S. Treasury Department, Treasury Bulletin, December 1981.

Exhibit V-3

TITLE XI NET ADDITIONAL GUARANTEE COMMITMENTS AS SHARE OF TOTAL NET FUNDS RAISED IN U.S. CREDIT MARKETS

(million dollars)

Year[1]	Title XI Net Guarantee Commitments Approved[3]	Total Net Funds Raised	Title XI as Percent of Total
1971	318	169,100	0.19
1972	537	205,100	0.26
1973	887	249,200	0.36
1974	1,183	230,800	0.51
1975	451	221,500	0.20
1976	737	297,000	0.25
1977	821	388,000	0.21
1978	-93	472,500	-0.02
1979	698	471,300	0.15
1980	838	438,600	0.19
1981	721	507,800	0.14
1982	325[4]	550,000[5]	0.06
1970-75 average	-	-	0.30
1976-81 average	-	-	0.12

[1] Title XI commitments are by U.S. Government fiscal year; July 1-June 30 through 1975; October 1-September 30 thereafter, with FY76 as the transition year. Total funds raised are by calendar year.

[2] First half data, at seasonally adjusted annual rate.

[3] Net additional Title XI contracts in force. Represents new commitments less repayments of guaranteed principal.

[4] Assumes $675 million FY1982 ceiling and repayments of $350 million.

[5] Projects an 8 percent increase in funds raised versus 1981.

Sources: Federal Reserve Bulletin, November 1981; Statistical Abstract of the United States, 1980; Maritime Administration; and TBS estimates.

Exhibit V-4

COMPARISON OF TITLE XI WITH OECD FINANCING TERMS

Summary of Terms:	Title XI	OECD
Interest rate:	15.0%	8.0%
Equity required:	12.5, 25%	20%
Maturity:	25 years	8.5 years
Repayment assumed:	level semi-annual principal plus interest	
Vessel cost assumed:	--------$40 million-----------	

Cash Flows: ($ millions)	Title XI 12.5% equity	Title XI 25% equity	OECD
Initial equity	5.0	10.0	8.0
Semi-annual payments	2.698	2.312	4.952
Outflow over 5 years	31.98	33.12	57.52
Discounted Cash Flows: ($ millions)			
NPV, first 5 years, 15% d.r.	23.52	25.87	42.00
NPV, first 5 years, 10% d.r.	25.83	27.85	46.24
NPV, lifetime, 15% disc. rate	40.00	40.00	54.72
NPV, lifetime, 10% disc. rate	54.26	52.21	63.83

NOTE: In addition to the equity provided for the capital outlay, the Maritime Administration requires owners to maintain appropriate reserve funds for working capital and to pay for all non-foreign-built material and equipment that has a U.S.-made equivalent.

Source: TBS calculations.

VI. ADMINISTRATION OF THE TITLE XI PROGRAM

The success of the Title XI program reflects consistent management by the Maritime Administration since the program began in 1938. The approval procedure for a Title XI guarantee requires economic soundness as the key criterion, combined with reviews of the applicant's financial strength, marine management experience, vessel technical suitability and performance, and adherence to legal eligibility requirements. A highly-skilled and experienced staff administers the program. Administrative costs are borne by the users.

Financial performance has been excellent due to strict approval standards and diligent administration. The revolving fund established for the program has been in surplus continuously to date, and retained earnings of $241 million were available as of September 30, 1981.

GUARANTEE APPROVAL EMPHASIZES ECONOMIC SOUNDNESS

The economic soundness of each project involving a Title XI guarantee must be approved by the Maritime Administration prior to issuing the letter commitment. A detailed application must be submitted, on which the prospective owner provides detailed information of the following types:

- Purpose of the project;
- Conditions in the intended market;
- Particulars of any applicable charters or transportation agreements;
- Projections of revenues, costs, and cash flow;
- A statement of operating experience;
- Design;
- Construction cost, estimates and quotation;

- Financing particulars;
- Financial statements; and
- An affidavit of the owners' U.S. citizenship.

This application is then carefully reviewed by analysts drawn from several divisions of the Maritime Administration, and coordinated by the Office of Ship Financing Guarantees. In every instance, the Maritime Administration will seek additional information and test the applicant's critical assumptions and forecasts.

The object of the economic analysis is to assure soundness of the venture. The analysis is not a capital budgeting exercise or a study to determine the optimal vessel for the trade. Rather, it is a pragmatic process to determine whether the vessel owner/operator can survive the critical first five years of the vessel's operation. A computerized analytical system has been developed by the Division of Economic Analysis to project five years of cash flows to demonstrate near-term solvency, defined as the ability to meet debt service and operational obligations. Breakeven analyses are conducted to determine the degree to which freight rates and utilization rates could fall while still covering costs. These are then compared to actual operating experience, market conditions and forecasts. Pro forma revenue-cost statements are generated, both for 100 percent utilization and revenues, and for the Maritime Administration's best estimate of expected revenues and utilization. Sensitivity analyses for interest rates, revenues and utilization are also performed.

DETAILED MARKET ANALYSIS SUPPORTS THE APPROVAL PROCESS

These analyses give the Maritime Administration a solid basis to determine whether the proposed vessel financing guarantee is economically sound. As part of the determination of likely revenues and utilization rates, in-depth forecasts of market conditions are utilized. The influence of future events (such as legislatively mandated changes in vessel design) on projected vessel demand in the intended trade, and the existing supply of vessels are considered.

APPLICANT MUST DEMONSTRATE STRONG RELATIONSHIPS WITH MARKETS

Depending upon the customary arrangements for a specific trade and the market outlook, charters for the vessel or contracts of affreightment may be required. The Maritime Administration also requires evidence that the owner or operator has satisfactorily performed some contingency planning for alternative uses of the vessel in the event of unforeseen market developments. Throughout the evaluation, active communication with the applicant helps to develop an economically sound solution.

THE APPLICANT AND THE PROPOSED VENTURE MUST BE FINANCIALLY SOUND

Operational and financial aspects of the proposed venture are central to the review process. If an operator will manage the vessel for the owner, the Division of Ship Management reviews the terms of the management contract for reasonableness and the competence of the operator. Charters are carefully analyzed to ensure that the terms are compensatory and well-structured. The proposed itinerary is scrutinized to check the compatibility of the vessel with its trade routes, ports in question, conditions and facilities, and the reasonableness of the proposed schedule. All costs submitted by the applicant are reviewed, and adjusted if necessary as input to the economic analysis. Finally, minimum working capital and net worth requirements must be met.

TITLE XI GUARANTEED VESSELS ARE TECHNICALLY COMPETITIVE

The Maritime Administration also reviews the Title XI application for the technical adequacy of the vessel. Plans are reviewed and the vessel is required to meet the highest standards of the American Bureau of Shipping and to pass applicable Coast Guard inspections. If Title XI construction financing is used, Maritime Administration construction representatives inspect the vessel periodically to confirm that industry quality standards are achieved to ensure adherence to the Buy-American provisions of the Title XI program. If requested by the Title XI program office, MarAd inspectors will certify whether a proposed shipyard has the capability to perform the work. In the case of a Title XI mortgage guarantee, the vessel will be inspected during construction and a representative will participate in the sea trials. Title XI covenants also require that the vessel be maintained to the ABS standards and with the proper Coast Guard certification. Each guarantee is secured by a preferred ship mortgage. These provisions protect the asset value and provide security for the mortgage guarantee in the marketplace.

THE PROGRAM RIGOROUSLY ENFORCES THE INTENT AND PROVISIONS OF THE LAW

Legal aspects of an application are also reviewed, particularly to ensure that the program benefits U.S. citizens. Title XI is available only to U.S. citizen vessel owners, and the determination of citizenship can be complex in the case of partnerships formed to own a vessel. MarAd enforces the Buy American provisions of the regulations by ensuring that the cost of foreign components is deducted from the actual vessel cost that is used to calculate the amount of the mortgage guarantee.

THE PROGRAM HAS BEEN FINANCIALLY INDEPENDENT SINCE ITS INCEPTION-- USERS HAVE PAID ITS WAY

The Title XI program has been financially independent of Federal Funds throughout its 44-year life. The stringent cost recovery from guarantee applicants is based on user fees that fully recover all program costs. The financial independence is also due to the prudent management of the program, application approval process, ship mortgage covenants, and the establishment of the Federal Ship Financing Fund. The program has not only paid its own way, but has maintained and increased substantial reserves in the fund even as the volume of guarantees outstanding has increased.

THE FEDERAL SHIP FINANCING FUND IS THE USER-PAID OPERATING AND RESERVE FUND

The Federal Ship Financing Fund is used as a revolving fund to underwrite the Government's guarantee and to pay the expenses of the program. Its income consists of the $1,000 application filing fees, investigation fees (generally about one-eighth of one percent) related to the application, and annual guarantee fees (between one-half and 1 percent for mortgage guarantees, and between one- quarter and one-half percent for construction loan guarantees).

The Fund pays for all salary and other expenses incurred by the Maritime Administration in operating the Title XI program. The Fund also makes payments of principal and interest to bondholders in the event of a default by the vessel owner and has been able to meet all contingent liabilities since the program's inception. Since the Maritime Administration holds a first preferred mortgage on the vessel, proceeds from an eventual sale of the asset return to the Fund and offset the payments made. Although the Maritime Administration is authorized to borrow from the U.S. Treasury in the event the Fund is not sufficient for making prompt and full payments under the guarantee; this has never been necessary.

TITLE XI RETAINED EARNINGS ARE INCREASING

The retained earnings in the Fund have more than kept pace with the volume of guarantees outstanding in recent years as shown in Exhibit VI-1. Since fiscal year 1974, the ratio of retained earnings to contracts in force has grown steadily, from 1.5 percent to 3.0 percent of guarantees outstanding as of September 30, 1981. During FY1980 and FY1981, retained earnings increased at the rate of 6 percent of the increase in contracts in force. These trends are positive indicators of the program's financial soundness.

THE TITLE XI PROGRAM HAS HAD MINIMAL LOAN DEFAULTS AND COMPARES FAVORABLY WITH COMMERCIAL LOAN EXPERIENCE

The default record has been excellent, with only 11 defaults during the 44-year history of the Title XI program. Cumulative net losses over the program's life have amounted to some 0.8% of total guarantee commitments extended, $81.3 million net loss on total mortgages guaranteed of $10.45 billion, as of September 30, 1981. On an annual basis, this loss record is extremely low, slightly more than 0.1 percent of outstanding commitments. This net loan loss record compares favorably with the experience of the largest commercial banks on their commercial loans, which have a much shorter average maturity than the mortgage loans guaranteed by Title XI.

THE TITLE XI GUARANTEE PORTFOLIO IS STRONGER THAN EVER

The Title XI program was created in 1938 in response to the need for American ships and the difficulties of securing financing. Marine finance is generally characterized by unforeseen risk, large sums of capital in the hands of small management organizations, and financial returns that are subject to trade fluctuations. The Title XI program has been highly successful as a stable vehicle for assisting with ship finance, consistently providing the financial community with sound projects.

The Title XI program is serving an ever broader range of quality projects. Those projects that service markets with very strong prospects complement those that are necessary to support markets where opportunities are stable or even declining. The rapid expansion of inland coal and grain markets requires that shippers be served by expanding capacity. By contrast, the Great Lakes steel industry and utilities markets look to owner/ operators to provide highly efficient coal, ore and limestone transportation to reduce total production costs, meet competition from imports and promote regional development.

The Title XI portfolio certainly faces no greater risk today than it has in the past. As the volume of outstanding guarantees has grown substantially, the retained earnings in the Fund have increased even more rapidly, to $241 million, with an annual net income of roughly $50 million. This level is considered fully satisfactory to cover possible defaults, since the amount at risk is only the difference between the market value of the asset and the unpaid balance of the ship mortgage. The Title XI program is also more secure because the vessel portfolio is much more diversified today, with oil drilling rigs, and inland tugs and barges as well as the traditional, oceangoing merchant ships.

Exhibit VI-1

RETAINED EARNINGS OF THE FEDERAL SHIP FINANCING FUND, AS A PERCENT OF GUARANTEES IN FORCE

($ millions)

Fiscal Year	Retained Earnings	Contracts In Force	Ratio, Percent
1970	25.1	911.6	2.8
1971	30.4	1,155.5	2.6
1972	38.1	1,697.5	2.2
1973	45.1	2,579.3	1.8
1974	55.3	3,762.7	1.5
1975	67.1	4,213.5	1.6
1976	89.6	4,950.9	1.8
1977	117.1	5,771.6	2.0
1978	122.7	5,679.0	2.2
1979	148.3	6,376.9	2.3
1980	190.5	7,215.0	2.6
1981	241.5	7,935.6	3.0

Source: TBS analysis of Maritime Administration data.

APPENDIX A

ECONOMIC IMPACT THEORY

This appendix briefly presents some of the concepts underlying the economic impact estimates given in the text. "Economic impact," as used in this report, refers to the stimulation of economic activity in various economic sectors due to the provision of an additional unit of output to final demand. The impact is measured as purchases of goods and services from other industries, both to supply the inputs needed for ship construction and to meet the consumer demand generated by household incomes arising from shipyard employment and indirect industrial payrolls. This economic impact can be quantified in terms of the revenues, employment and payrolls generated in various industrial and service sectors.

The economic impact of the Title XI Program derives from the construction of vessels in U.S. shipyards, financed with the assistance of Title XI guarantees. The value of vessel construction aided by the program thus provides the basis for the impact calculation. Three types of impact are estimated:

- Direct impact, equal to the value of ships delivered;
- Indirect impact, reflecting inter-industry purchases in support of shipbuilding suppliers; and
- Induced impact, expressing the multiplier effect of household expenditures.

The direct impact consists of the component costs of the delivered vessel, and the employment and payroll generated in the shipyard. The inputs to ship construction are supplied roughly half from within the shipyard ("value-added," equal to wages and salaries, depreciation, rent, interest expense, profits, and indirect business taxes) and roughly half from external suppliers of materials, services and components (see the breakdown provided in Exhibit II-1). Direct revenue impact thus consists of the value-added by the shipyard and the direct purchases from suppliers, such as purchases of steel, engines, pumps, and engineering services. Direct employment is estimated based on U.S. Department of Commerce Census of Manufactures data. Payroll is estimated as a percentage of shipyard output.

The inter-industry (direct plus indirect) impact is obtained from an input-output table. A matrix is prepared showing the quantity (value) of each industrial product, listed by rows, required to deliver a unit of output from the industry named at the head of each column. By summing up a column, one can determine the total value of industrial production needed throughout the economy in order to supply a unit of the desired output. This figure is termed the "multiplier", because applying it to the value of additional output desired gives the total direct and indirect requirements. To avoid double-counting in the inter-industry matrix the analysis must separate the portions of output which represent final demand by the economy, and those which serve as intermediary inputs into another industry. Final demand consists of consumption, investment, government spending, and net exports. Because Title XI exclusively supports construction or reconstruction of marine equipment, which is treated as investment (capital formation), the entire output is considered delivered to final demand.

Impact analyses generally rely upon the U.S. Commerce Department's input-output tables, which are prepared at five-year intervals based on the Census of Manufactures. The most recent input-output data for the U.S. economy are those reflecting the 1972 structure of industry. These data were arranged and manipulated by Professor H. C. Chung for the Maritime Administration, and the resulting report (Economic Impact of Maritime Industries on the U.S. Economy, 1971-1978, 1981) is the source of the multipliers used in the present analysis. These multipliers were applied to updated figures of the relationships between payroll, employment and output in the shipbuilding industry. Alternative data prepared by Data Resources, Inc. (The Economic Impact of the U.S. Shipbuilding and Ship Operating Industries, 1979) indicate that the Chung multipliers are conservative. It should be noted, however, that these multipliers are approximations, based on aggregated and partially-estimated data for the U.S. economy.

Induced impact differs conceptually from indirect impact. The induced impact is an income effect, tracing the wages and salaries paid to workers of directly and indirectly affected industries as they are spent by households, and subsequently re-spent throughout the economy. This spending cycle gives rise to a Keynesian-type multiplier. Multipliers giving the combined effect of direct, indirect, and induced impacts can be computed by treating the household sector as one of the supplier industries, adding it as a row to the inter-industry input-output table. The household sector is then removed, however, from the exogenous final demand. A further adjustment is made by excluding the personal income earned by the household sector, so that the multiplier includes the induced effect, but only on the output of the economic sectors. The present study utilizes induced impact multipliers developed by Professor Chung in the report previously mentioned.

STATEMENT OF THE BOEING CO., SEATTLE, WASH.

SUMMARY

The Boeing Company respectfully suggests consideration be given to revising the way the credit activities of the Export-Import Bank are presented in the Federal Budget so that its actual costs, if any, are known when Congress establishes annual limits on the Bank's direct lending and loan guarantee programs. The present Federal Budget is seriously defective in this respect.

This submission reviews why Eximbank loans and guarantees are important to Boeing and the United States economy.

The concluding section summarizes efforts currently underway to negotiate international agreement on a new way to finance commercial aircraft without government subsidies; Eximbank guarantees are likely to be required at least for a transitional period.

END OF SUMMARY

The Boeing Company appreciates this opportunity to provide the Task Force with comments on the credit activities of the Export-Import Bank.

Although Boeing does not itself receive any Eximbank loans or guarantees, our overseas customers are among the major recipients. We are, accordingly, keenly interested in legislative initiatives that may affect the continued availability of Eximbank credit to support commercial aircraft sales abroad. The way Eximbank is dealt with in the Budget could have a profound effect on this matter.

Boeing's overseas sales of commercial aircraft have made us this country's leading industrial exporter for several years. Our new generation, fuel-efficient models currently in production offer promising prospects that Boeing may continue to be a major supplier of the world's needs for new jetliners throughout this decade. The numbers involved are staggering: we estimate some $125 billion will be spent by airlines worldwide this decade on new equipment. About 60% of it will be by foreign carriers.

Financing is often the critical factor in an airline's choice of equipment offered by competing suppliers. Eximbank loans and guarantees have been indispensible over the years in enabling foreign purchasers to secure financing for Boeing jetliners comparable to officially-supported export credits available from Western European governments for Airbus customers. In an attempt to reduce the costs of export credits at subsidized rates, the U.S. and European governments have entered into various agreements over the years. This is not the place to attempt to review the complex history of these negotiations but, insofar as financing of commercial aircraft is concerned, it is important to note that the U.S. Government has agreed that Western European Governments may offer official export credits for Airbus at 12% for 10 years. The agreement also authorizes officially-supported U.S. export credits through Eximbank at the same rate and tenor for Boeing and other U.S.-origin commercial aircraft. If Eximbank lacks either the necessary funds or the will to provide export credits at competitive rates, customers will increasingly opt for Airbus. Some recent Eximbank policy actions, we regret to say, have demonstrated how quickly and easily a Boeing sale can be lost to Airbus when Eximbank fails to provide support to match the rates the U.S. Government has agreed the government owners of Airbus may offer.

Lost sales of expensive items like commercial jetliners ripple through the U.S. economy because many thousands of first-and second-tier subcontractors and suppliers are involved in producing the multitude of parts and equipment that go into the final product. Fewer sales reduce income, profits and tax revenues, they force production cutbacks and reduced employment thus reducing personal income and tax revenue while raising welfare costs. Based on Chase Econometrics data, the Aerospace Industries Association has calculated that jet transports financed by Eximbank yield benefits to the U.S. Government 24 times the cost to Eximbank of matching the foreign government lending rates.

The recent rapid increase in total Federal borrowing has quite properly begun to attract increasing attention. Disclosures that some programs manage to escape control altogether while others may be acting contrary to Congressional intent have quite legitimately led to proposals for more scrutiny and control. The Boeing Company fully endorses the need for more transparency and better discipline over Federal credit. We are concerned, however, that undifferentiated attacks on the totality of Federal credit activities may do unnecessary damage to the economy. Every major credit program should, we believe, be examined carefully to try to get as accurate answers as possible to questions like is the program doing what it is supposed to do, is the function still important, are it's operations controllable and under effective control, how much does it cost, who pays, and can we afford it?

The Boeing Company has no fear of such a scrutiny of Eximbank operations and programs. It is on-budget. It is subject to annual limits on credit commitments. It involves no appropriations. And its functions are vital for the reasons indicated above.

The accounting methodology used for the Federal Budget may be partly responsible for some of the misconceptions about what Eximbank operations actually cost. The figures for new direct loan obligations and new loan guarantee commitments are the only ones highlighted in the Budget and this creates an impression that Eximbank costs billions of dollars every year.

The truth is, Eximbank may experience the first operating loss in its history this fiscal year. Eximbank estimates the loss may be $117 million. But for 30 years before this year, Eximbank has made profits and - until FY80 - returned an annual dividend to the Treasury. (Eximbank revenues also pay for the costs of administering the Bank.)

If the Federal Budget presentation of Eximbank operations could be modified, perhaps by incorporating data from the Bank's Annual Reports, decisionmakers would be able to recognize immediately that this is a bank with income as well as outflows, repayments as well as borrowings. The bottom line could be a forecast for the upcoming fiscal year whether a profit to the Government can be anticipated, as usual, or whether special factors, like this year, may mean a relatively modest operating loss requiring a drawdown of the Bank's own capital stock (but no appropriations of taxpayers funds).

Similarly, the Federal Budget presentation of Eximbank new loan guarantees would be more accurate if a footnote drew attention to the fact that this particular contingent liability of the Government involves only trivial costs, if any, because defaults are so rare and revenue from insurance and guarantee fees greatly exceed claims paid. In FY81, for example, net guarantee claims paid amounted to $3.3 million or 4/100 of 1% of new loan guarantees while Eximbank revenues from insurance premiums and guarantee fees were nearly $37 million.

A straightforward, factual presentation of how little Eximbank actually costs could do a great deal to dispel the myth that it involves handouts to big business amounting to billions and billions of dollars every year.

Finally, we would like to be sure the Task Force is aware of current efforts to get all governments out of the business of subsidizing export credits for commercial aircraft. An adequately funded, aggressive Eximbank will be needed to give U.S. negotiators some credibility.

The U.S. Aerospace Industries Association, at Boeing initiative, has developed a specific proposal that would make financing a neutral element in commercial aircraft product selection. The proposed new financial instrument - an International Equipment Trust (IET) - would mobilize private long-term capital at market rate and market term and eliminate the need for direct government lending at subsidized rates. It would also benefit customer airlines by extending the duration of loans to the useful life of the aircraft, thus reducing their annual debt service burden.

Eximbank guarantees may be indispensible to make something like the IET operational. They will be needed for technical reasons to open up access to long-term institutional lenders. A government guarantee will permit foreign loans to be domesticated and thus comply with certain restrictions in this area. But government guarantees may not be necessary indefinitely. Experience and confidence with a subsidy-free, market-rate, market tenor system may permit private insurance ultimately to replace government guarantees. But even if government guarantees prove to be needed longer that we hope would be the case, it is important to keep clearly in mind how improbable it is that such guarantees will require payment of public funds. There are good reasons for the remarkable record of very small claims on Eximbank guarantees for commercial aircraft: a commercial jetliner is a mobile asset offering several benefits to secured creditors including protection in the many countries throughout the world who have signed the Convention on International Recognition of Rights in Aircraft, the Geneva Mortgage Convention.

The proposal for an IET, or some mutually-acceptable variant of it, offers a way to stop wasteful competition among national Treasuries. Meanwhile, maintaining a strong, aggressive Eximbank can help convert this attractive possibility into a reality.

**National Association
of Independent
Colleges and Universities**

Suite 503
1717 Massachusetts Avenue N W
Washington D C 20036
202/387-7623

March 8, 1982

Senator Slade Gorton, Chairman
Task Force on Federal Credit
Senate Budget Committee
Carroll Arms - Room 203
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the National Association of Independent Colleges and Universities, which represents 875 independent college and universities, 43 state associations, and 28 special purpose organizations, we thank you for the opportunity to submit written testimony to the Senate Budget Committee's Task Force on Federal Credit regarding the three loan programs authorized by the Education Amendments of 1980. These three loan programs include: the Guaranteed Student Loan program (GSL), the National Direct Student Loan program (NDSL), and the Auxilary Loans to Assist Students program (ALAS) -- originally called PLUS for Parent Loans to Undergraduate Students. Our comments will focus on the relationships between these three higher education loan programs and the federal credit budget.

The higher education loan programs were revised for Fiscal Year (FY) 1982 as part of the Congressional effort to set budget ceilings which would reduce the federal deficit to $35 billion. The Higher Education Act of 1965 was amended by the Omnibus Budget Reconciliation Act of 1981 to limit loan volume and transfer a larger share of the program costs to the borrower. Since these changes did not become operative until October 1, 1981, when most students had finalized their financial plans for this 1981-82 Academic Year, the cost savings were quite limited. The real savngs will come during the 1982-83 Academic Year (FY 83).

In recognition of both individual and national needs, the federal government has established an array of student assistance programs designed to assure broader access to higher education by providing resources to supplement the financial efforts that students and their families are able to make. The federal commitment has been to ensure that no student aspiring to higher education shall be denied access to the college of his or her choice because of family economic circumstances.

Each of the seven federal student aid programs seeks to ration limited resources among the nation's neediest students. (In student aid terminology, "need" refers to the gap between what a student's family can be expected to contribute, including student earnings, and the cost of education.) The mosaic of different aid programs responds to the different pricing mechanisms at independent and public institutions, the policy differences among states, and the objective of spreading scarce federal resources as far and as equitably as possible by creating grant, work, and loan programs with varying conditions of participation. For millions of American college and university students, these seven programs, developed over the last 24 years, have provided access to independent higher education. Because of the different pricing policies of independent and government-subsidized institutions of higher education, students with the ability and aspirations to choose an independent college or university have found that they need to package several of the federal student aid programs together in order to meet their educational costs. This has been the case even for students who make a substantial financial effort themselves, and with the help of their families.

The Guaranteed Student Loan Program was authorized by the Higher Education Amendments of 1965 to encourage the use of private capital in helping students and families finance the cost of postsecondary education. Financial institutions participate in this program on a voluntary basis. Since its inception, the GSL program has undergone a series of refinements and revisions to ensure that it would work effectively. These changes involved improving the mangement of the program, the criteria for eligibility, and determining the federal subsidy that financial institutions receive in return for their participation.

Federal program costs are incurred for the incentive subsidies paid to lenders, and for death, default, and disability claims. The first incentive payment to lenders is the in-school interest subsidy while the borrower is in school and during the six month grace period after the borrower leaves school. The second incentive payment is the special allowance paid to the lender each quarter over the life of the loan, to compensate for the difference between the borrower's interest rate (7 or 9 percent) and the lender's cost of money.

The changes made by the Reconciliation Bill in the GSL program mandated:

-- an income ceiling of $30,000 on automatic eligibility to receive interest subsidy benefits, above which financial need must be documented by a needs test;
-- a maximum annual loan limit of $2,500, and a cumulative loan limit of $12,500 for all undergraduates;
-- an origination fee of 5 percent;
-- an increase of the minimum annual repayment amount from $360 to $600; and
-- elimination of grace periods following deferments.

According to the Congressional Budget Office, these legislative changes will result in savings of only $479 million for FY 1982, but then $855 million for FY 1983, and $1.353 billion for FY 1984.

The Administration has proposed additional changes with its FY 1983 budget which would:

-- require demonstrated need for all loans regardless of income;
-- increase the origination fee to 10 percent;
-- eliminate graduate and professional students from eligibility to borrow;
-- increase the insurance premiums paid by students when they borrow under the program; and
-- limit special allowance interest benefits to in-school and deferment periods plus a two-year period following graduation or withdrawal from school, at which point the interest rate on the loan would rise to market rates.

The Administration estimates these changes would result in additional savings of $309 million for FY 1982, then $912 million in FY 1983, and $1.17 billion in FY 1984.

The National Direct Student Loan Program (NDSL) was established under Title II of the National Defense Education Act of 1958, to provide payments for postsecondary educational institutions to make long-term, low-interest loans to qualified students who need such financial assistance to pursue a course of study on at least a half-time basis. The Reconciliation Bill increased the interest rate on an NDSL loan from four to five percent (ten months earlier it had been increased from three to four percent); and the authorization level for new federal capital contributions was held constant at $286 million for fiscal years 1982, 1983, and 1984.

The Administration's FY 1983 budget proposal would eliminate all federal capital contribution for the NDSL program -- leaving institutions in the position of being able to lend only the amount of funds built up in their revolving funds. Some colleges and universities, because of their late start in the program, have very small revolving funds and this would put them at a considerable disadvantage in providing such financial assistance to their needy students.

In addition, it should be noted that changes made in the NDSL program produce no immediate savings to the federal government. An increase in the interest rate eventually will increase an institution's revolving fund, but not until students begin loan repayments in four to five years. Further, if the interest rate continues to increase in the NDSL program, it will distort the true mission of the program and make it no longer able to serve the constituency for which it was designed. Any reduction in NDSL funding will cause students to seek other aid sources, but many of these programs are scheduled to be reduced or eliminated under the FY 1983 budget proposals. Students will then be forced to seek a GSL loan, but many students who currently utilize the NDSL program are not considered credit worthy by the banking community, and probably could not obtain a GSL loan.

The Auxiliary Loans to Assist Students program, originally called the PLUS program (Parent Loans to Undergraduate Students) is the newest of the federal financial assistance programs. It was authorized by the Education Amendments of 1980 to provide additional capital to parents. Even before it was fully put into effect, it too was significantly changed by the Reconciliation Bill. Under current law, loans are available to independent undergraduate students, parents of dependent undergraduate students, and all graduate students. The maximum annual loan available to parents of undergraduate students and to graduate students is $3,000 and $15,000 cumulatively. Independent undergraduates may borrow up to $2,500 per year, but the combination of PLUS and GSL loans may not exceed either the undergraduate yearly loan maximum of $2,500 or the aggregate maximum of $12,500. The interest rate charged the borrower is 14 percent, with a special allowance paid to lenders by the federal government up to the lender's costs of money. No in-school interest subsidy is provided, and borrowers must begin repayment within 60 days after taking out the loan.

The PLUS program became operational during 1981, as 23 states began operations. However, not many loans have been made under the program, since many lenders and guaranteed agencies have been reluctant to begin lending under a new federal program which was authorized during the second session of the 96th Congress, was amended during the First Session of the 97th Congress, and is subject to additional program changes under the Administration's FY 1983 budget proposals.

Under the Administration's budget proposal, graduate and professional students who were eliminated from eligibility for GSL loans would be able to borrow under this program. The loan limits would be increased to $3,000 to $8,000 per year, and from $15,000 to $40,000 overall. For a program that has only been in existence since October, 1980, and which has been and continues to be subject to major substantive changes, it appears very unrealistic to believe that it could accommodate the entire graduate and professional student population in need of this type of financial assistance.

The Pell Grant, Supplemental Educational Opportunity Grant, State Student Incentive Grant, and College Work-Study programs complete the package of federal student assistance. They provide grant and work assistance to low- and middle-income students. All seven of the student financial aid programs are essential and each is dependent upon the other to provide the best form of assistance to students to ensure them choice and access in obtaining a college education. Within independent higher education, six out of every ten students rely on one or more of the seven federal student assistance programs.

Any change in the seven student financial aid programs will effect the whole process of packaging assistance which is critical for higher-priced institutions. The Administration's FY 1983 budget proposals for the student assistance programs will force millions of students to change their educational plans or to forgo college attendance altogether. If State Student Incentive Grants, Supplemental Educational Opportunity Grants, and the National Direct Student Loan programs are eliminated, and Pell Grants and College Work-Study funds are reduced as the Administration proposes, students will be forced to rely on the GSL program even more than they presently do. However, with the proposed changes to the GSL program, even that last resort program of assistance will not be available for many of the most needy students. No reasonable or available means of financing higher education will be operational. We believe it is counterproductive for the federal government, after 24 years of steady bipartisan commitment to these higher education aid programs, to remove itself from this investment in our nation's future, and we urge you to reject the Administration's proposals.

We appreciate this opportunity to share our concerns with the Senate Budget Committee's Task Force on Federal Credit. If we could provide any additional information to assist the Task Force, we would be pleased to do so.

Sincerely,

John Phillips
NAICU President

Statement of Robert D. Partridge, Executive Vice President
National Rural Electric Cooperative Association,
before the
Credit Budget Task Force of the Senate Budget Committee

Chairman Gorton, and distinguished members of the Credit Budget Task Force of the Senate Budget Committee. . .

My name is Robert D. Partridge; I am Executive Vice President of the National Rural Electric Cooperative Association, a voluntary national service organization, comprised of nearly 1,000 rural electric cooperatives which operate in 46 states and serve more than 25-million consumer members.

With your permission, Mr. Chairman, I will submit for the hearing record several documents which support and amplify the information contained in this statement, including a resolution entitled "Credit Budget Review" which was approved by the NRECA membership at our recently concluded 40th Annual Meeting.

Let me begin my statement, if I may, by assuring the members of this Task Force that the NRECA -- and, I believe, the vast majority of the rural citizens served by our rural electric co-op members -- are in full accord with your objectives, and agree that top priority must be placed on solving our nation's severe economic crisis.

Our consumers throughout rural America, many of whom are farmers, ranchers and small businessmen who must use credit to operate, are being especially hard hit by today's high interest costs and economic instability. Rural people are aware of -- and a great many share your concern about -- the degree of influence which Federal borrowings have on the overall cost and availability of capital, and we applaud your efforts to gain a better understanding in this area.

At the same time, however, rural people are deeply concerned about the future of the REA financing program -- a program which has brought about substantial and well-documented social and economic improvements which have benefited not only rural areas, but the nation as a whole. In this light, then, we feel it is extremely important that the Task Force have a full understanding of:

1. How the REA loan program evolved to its present state;

2. The extent to which Congress can -- and does -- exert direct control over the volume and focus of REA lending activities, and,

3. The unique and, we feel, mutually beneficial relationship which now exists among REA, rural electric borrowers, and the credit marketplace.

BACKGROUND

Until 1973, REA lending relied on funds directly appropriated for this purpose each year by the Congress. These funds were treated in the Federal budget as expenditures rather than loans, with the principal and interest repayments from co-ops going to the U.S. Treasury as general revenues, with no offsetting credits allocated to the REA program. To the extent that funds were available in a given year, borrowers were able to acquire 100% of their capital needs through REA, and except for some variance during the very earliest years of the program, all loans were made at a two percent interest rate. As rural areas began to grow both in population and in their demand for electric energy, however, the gap between the amount of loan funds available and the needs of REA borrowers grew ever wider, resulting in a substantial backlog of loan applications.

In 1973, however, several major changes took place. The REA direct loan program -- along with its dependence on annually appropriated funds -- was for all practical purposes terminated. In its stead, Congress created two new REA loan authorities: REA insured loans, designed to meet the capital needs of local rural electric distribution systems, and REA guaranteed loans, meant to make it possible for rural electrics to undertake major construction projects, most often in the generation and transmission areas.

To provide a new funding source for the REA insured loans, Congress in 1973 created a Rural Electric and Telephone Revolving Fund. Originally capitalized with the asset value of REA's outstanding loans, and a small amount of cash in unexpended loan funds, the revolving fund was designed to be largely self-replenishing through the inflow of principal and interest repayments on existing and new REA loans, and by "rolling over" existing notes through the sale of "Certificates of Beneficial Ownership" in them. Under this arrangement, there has been no need for additional funds to be appropriated for REA loans since 1973.

According to the terms of the new insured loan program, REA could make loans to qualified borrowers at either a five or two percent interest rate, depending on the individual applicant's consumer density and/or financial strength. Between 1973 and 1981, only a small percentage of these loans were made at the special two percent interest rate. Most were made at the standard five percent rate, and of these, the vast majority covered only 70% of the borrower's total need, thereby requiring the co-op to acquire 30% of its capital from non-REA sources at full market rates. With legislative changes made in 1981, there no longer are any situations in which the use of the two percent interest rate is mandatory, although the Administrator of REA retains the authority to make loans at rates between two and five percent in cases of extreme hardship.

The REA loan guarantee program, also created in 1973, likewise operates totally without the use of appropriated funds, with REA and the Federal Financing Bank acting as a guarantor and conduit for funds acquired in the private capital marketplace. REA borrowers utilizing this program are nearly all power supply cooperatives engaged in the construction and operation of large generating and transmission facilities. Loans made under the REA guarantee carry an interest rate fully equal to the FFB and Treasury's costs of acquiring these funds, with a one-eighth percent service fee added on to cover administrative costs. Through this fee, the federal government makes a "profit" of some $6-million per year through the placement and servicing of REA guaranteed loans.

In terms of volume, REA approved some $8.3-billion in loans to 1,094 different borrowers through the direct loan program in operation from 1935 to 1973. Since the institution of the "new" loan programs in 1973 and through September 30, 1981, REA has provided an additional $7.1-billion in insured loans and $26.2-billion in loan guarantees to rural electric borrowers. Of these loans, more than $6.9-billion has been repaid, including $4.1-billion in principal and $2.8-billion in interest.

The administration of both programs by REA entails a very well established and effective procedure for evaluating and processing loan applications. I have attached to my statement a review of the key steps in this process for the information of the task force. The efficacy of this aspect of the process is well demonstrated by the fact that in the history of the program there have been only two defaults on loans, both of which occurred in the 1940's. Neither involved an operating electric cooperative, and the total amount defaulted was $37,237. There has never been a default of any kind on REA guaranteed loans.

CONGRESSIONAL OVERSIGHT

Because neither the insured nor guaranteed loan program depends on appropriations for the funds it provides to borrowers, a specific provision was included in the 1973 amendments to the Rural Electrification Act which excludes these loans from the federal budget. This by no means limits in theory or in practice the degree to which Congress can exercise control over the size and scope of the REA lending activities.

With regard to the insured loan program, Congress sets annual "floor" and "ceiling" levels within which the REA must operate. These limitations are included in the Agriculture and Related Agencies Appropriations bill enacted for each fiscal year, and are based on information provided to the the Congress from several key sources. One source is REA itself which, after consultation with the Office of Management and Budget and other agencies, recommends loan activity levels it deems to be appropriate. Another source is the rural electric borrowers themselves, speaking through their national association, NRECA. Specific recommendations are made based on the borrowers own projections of capital needs as determined through an annual loan fund survey. In addition, other interested parties can make their views known to Congress through the hearing process.

A similar procedure is in effect for the REA guaranteed loan program. Here also, Congress reviews the information it receives on projected need and other factors which it receives from REA, NRECA and other sources, and sets a floor and ceiling limitation on the year's loan guarantees. An additional measure of control is available through a provision in the law which requires the REA Administrator to provide Congress with no less than 30 days advance notice of his intent to approve a loan guarantee application. The Administrator also is required to provide the Congress with information on the cumulative total of loans approved with each notification of an intended guarantee. In addition, REA must also publish a notice in the Federal Register, 30 days in advance of new guarantee loan commitment the Administrator intends to approve.

It's evident, we believe, that Congress has a very effective and real opportunity to closely monitor and control the activity of the REA loan programs. This mechanism allows the Congress to fully evaluate the need of the rural electric systems to raise new capital, and balance that need with the current capability of the federal government -- through REA -- to assist them in acquiring it. Of course, the overall condition of the credit marketplace can be, and is, an important factor considered by Congress in exercising its controls over the REA program.

CREDIT AND THE ROLE OF RURAL ELECTRIFICATION

Rural electric cooperatives, like every other type of utility, have a unique relationship with and responsibility to their consumers. As far as electric power is concerned, consumers have come to expect, and depend upon, the ability of utilities to meet all of their needs. The reliability of the American power system is second to none simply because rural cooperatives, municipals and power companies all have taken this special "utility responsibility" very seriously over the years. And, I believe, the people of our nation will continue to expect adequate and reliable service in the future, and depend on the utility industry to do whatever is necessary to provide that service.

What this fact means insofar as credit demand is concerned is that unlike many other businesses, the utility industry's need for new capital entails very little discretion. Utilities build new facilities because they must build them to meet their consumers needs. And they must raise the capital needed to build these facilities one way or another when they need it, regardless of how good or bad the credit market may be at that particular time. For most electric utilities, the option of not building the facilities they need is one choice that is not available to them.

Such is the case with the rural electric cooperatives. We borrow for one reason and for one reason only -- to build the facilities needed to provide adequate and reliable service to our member-consumers. Cooperatives borrow from REA to maintain, expand and improve a service which the nation's rural areas cannot do without, and they will have to continue to borrow -- one way or another -- to meet these needs in the future.

Reducing the size and scope of the REA program therefore, would have little if any impact on the actual credit demand of rural electric systems. It would, however, have a very major impact on the cost of that borrowing and -- since co-ops are non-profit and costs necessarily flow-through to their members -- would also greatly increase the electric rates rural consumers must bear. These rates, it should be noted, already average appoximately 12% higher than those charged to urban and suburban consumers served by other types of utilities. Cutbacks in the REA program would make this rural-urban inequity even more severe, but would have no discernable impact on the overall credit marketplace.

This Congress and the present Administration have acknowledged the important role of electric energy and the financial plight of the investor owned utility industry by providing them with significant new subsidies through the granting of a broad range of new tax credits and advantages. We are sympathetic to these steps because we are fully aware of the difficulties these utilities have had in recent years in meeting their capital needs. At the same time, however, we are seriously concerned by the Administration's continuing inability or unwillingness to support an adequate REA financing program to help meet the equally important capital needs of the rural electric cooperatives.

In summary, we fully support efforts to get the nation's economy back on an even course, and applaud this task force's efforts to examine this problem from the credit perspective. We also, however, emphasize our present and continuing accountability to the Congress, and point with pride to our responsible record of repayment. Finally, we welcome any objective review of the rural electric program and its contribution to the productive capacity of the nation.

Thank you very much for this opportunity to have our views heard.

REVIEW OF LOAN APPLICATIONS BY REA

(1) REA borrower submits loan application packet to REA Operations Field Representative (the local area office). The OFR makes initial determination as to need for financial assistance, ascertains that borrower eligibility requirements are met, and determines that loan documents are in order prior to forwarding to REA Washington offices;

(2) Loan applications for insured loans are forwarded to the respective Area Office (Northeast, North Central, Southeast, Southwest, or Western) at REA in Washington. Area Office reviews and separates various segments of packet for analysis by other divisions. Loan applications for guaranteed loans are sent onto Power Supply Division;

(3) Respective segments of packet undergo analysis and review by the Engineering Standards Division, the Environmental & Energy Requirements Division, and the Energy Management and Utilization Division;

(4) Final staff review of all loan applications is made by the Electric Loans and Management Division, which re-assembles the various segments of the loan packet, and prepares and gathers any needed supplemental information pertinent to the loan. The division also recommends, to the REA Administrator, whether a loan merits his approval;

(5) The loan packet, complete with any recommendations by the REA staff, is set to USDA's Office of the General Counsel to assure compliance with legal requirements is met;

(6) The loan application packet is forwarded to the Assistant Administrator for consideration; and finally,

(7) To the REA Administrator.

CREDIT BUDGET REVIEW

Legislative changes are being proposed to review annually all federal credit programs and establish a limited credit budget. P.L. 93-32 established a strict procedure for congressional review and authorization of the REA insured and guaranteed loan programs. The congressional appropriations committees annually set a floor and ceiling on REA insured loans. Each loan guarantee is subject to review by Congress 30 days prior to approval, and Congress is also regularly informed of the year's cumulative total.

The comprehensive review of the REA loan program completely meets the Congressional interests in controlling federal credit. Other credit programs should be similarly reviewed and restricted consistent with the increasing Congressional concerns in this area.

We oppose any additional review of the REA program as being redundant and unnecessary.

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 AM
THURSDAY, JUNE 3, 1982

STATEMENT OF LAWRENCE A. KUDLOW
ASSOCIATE DIRECTOR FOR ECONOMICS AND PLANNING
OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am pleased to appear before you today to discuss the Administration's views on the recapitalization proposal for the Federal Home Loan Mortgage Corporation (H.R. 6442).

As you know, in recent months the Administration has conducted a thorough and comprehensive review of the proposal, and after full consideration of the issue it was decided recently to oppose the FHLMC recapitalization plan. The central features of this decision were:

1) Passage of the bill would encourage a substantial expansion of the operations of FHLMC while it is still closely linked to the Federal government. As a result, this proposed expansion of a government-sponsored enterprise would significantly add to the already excessive amount of federally-assisted debt, thereby burdening the financial markets with yet more government-related bonds and generating upward interest rate pressures which would substantially threaten the anticipated recovery in housing.

2) On balance the bill would not advance the key objective of FHLMC privatization. Instead, important linkages to the Federal Home Loan Bank System and the Federal government would be left in existence. Moreover, with a significant expansion of this quasi-government agency, it is likely that the early development of private sector counterpart institutions will be impeded by the special privileges of still another fast-growing federally-backed agency.

3) Instead of the present recapitalization proposal, the Administration believes that efforts should be made to better utilize FHLMC's first-rate management, solid marketing position, and positive earnings trend by seeking ways to sever all Federal government linkages with the agency within a specified time interval, thus placing the corporation squarely in the private sector. This approach would be consistent with Administration policy to reduce all forms of federal and federally-assisted credit and to spin off federally-related agencies into the private sector whenever possible. This approach would also be consistent with Administration objectives designed to strengthen the market- oriented private economy as the most reliable instrument of sustained economic expansion.

Background

The Federal Home Loan Mortgage Corporation expects to finance its aggressive program of conventional mortgage-backed securities by raising new capital from the private credit markets in order to package conventional mortgage loans purchased from private lenders and resold to institutional investors. In this fashion it is hoped that FHLMC will expand the secondary market outlet for private lenders of conventional home loans. By matching the yields of its loan purchases with sales of mortgage participation certificates (PCs) guaranteed by the agency, FHLMC has been able to avoid the negative spread problem experienced by FNMA and thrift institutions.

The FHLMC recapitalization proposal would restructure and broaden the corporation's ability to raise capital. The major provisions of the bill include:

- o The conversion of $100 million (book value) of non-voting common stock held by the 12 Federal Home Loan district banks to voting common stock.
- o The corporation would be allowed to raise capital directly in the credit markets rather than raising funds through the Federal Home Loan Bank System.

- The bill would authorize an emergency back-stop to the FHLBB system of $200 million.

- The bill would change control of FHLMC from the three members of the FHLBB to an expanded board of directors totaling nine members. Three members of the FHLBB would continue to serve, along with six members elected by the stockholders. The chairman of the FHLBB will serve as chairman until 1985, when a new chairman is elected by a majority vote of the board.

The Problem of Federal Credit Absorption

Assuming enactment of the bill, FHLMC has reported to the Office of Management and Budget that it expects to generate $20.9 billion in new loans for FY 1982 and another $23.4 billion of new credit in FY 1983. This would represent an increase of nearly 600% over the 1978-81 period, when FHLMC loan expansion averaged $3.2 billion. Similarly, it would raise FHLMC's share of all government-sponsored agency debt from 10.7% to 41.5%.

GOVERNMENT-SPONSORED ENTERPRISES: NET CHANGE IN OUTSTANDING LOANS
(in billions of dollars)

	4 year averages		Annual Data					
							Estimates	
	1970-73	1974-77	1978	1979	1980	1981	1982	1983
Federal Home Loan Mortgage Corporation 1/	0.5	1.5	4.4	5.0	3.1	0.3	20.9	23.4
Federal National Mortgage Association	3.3	2.8	7.0	8.0	6.5	4.1	12.6	12.5
Federal Home Loan Banks	1.2	1.5	12.1	9.9	6.5	20.5	4.6	5.0
Farm Credit Administration	1.8	4.8	4.4	8.5	12.5	10.0	11.9	13.2
Student Loan Marketing Association	---	0.1	0.2	0.5	1.0	2.1	1.6	1.4
Total, unadjusted	6.8	10.7	28.1	31.9	29.6	37.0	51.6	55.5
FHLMC as percent of total	7	14	16	16	10	1	41	42
FNMA as percent of total	49	26	25	25	22	11	24	23

1/ Assumes enactment of S. 1805.

Since taking office over a year ago the Administration has consistently sought to implement a federal credit policy of reduction, not expansion. The proliferation of federal and federally-assisted borrowing in all areas -- direct loans, loan guarantees and government-linked agencies -- has become one of the major obstacles to lower interest rates and economic recovery.

It is now widely recognized that the excessive expansion of federal credit has created significant resource misallocation throughout the economy. This government misdirection of scarce investment resources has reduced overall economic efficiency and has impaired the productivity of capital. Funds better left in private sector hands have instead been consumed by the federal government for purposes which are substantially less productive in both the short and long run.

In the 1960's the absorption rate of domestic credit market funds by the federal government registered between 15 and 20%. During the 1970's, however, the federal absorption rate averaged about 28%, and in 1982 and 1983 it is estimated that the absorption rate is likely to exceed 50%. The economic impact of this enhanced capital consumption by the Federal government has been unmistakable. In contrast to the 1960's, unemployment, inflation and interest rates on average during the 1970's and early 1980's have been substantially higher than the previous decade. The growth of real GNP, real capital and productivity has slowed markedly in comparison to the previous period.

	GNP Deflator (%)	Real GNP (%)	Unemployment Rate	20-yr T-Bond	Fed. Credit Absorp. Rate
1960-69	2.6	4.2	4.8	4.6	16.3
1969-73	5.0	3.6	5.0	6.5	21.5
1973-81	7.9	2.3	6.7	9.1	28.3

Numerous factors have been at work in the gradual but steady deterioration of the domestic economy. Misguided pursuit of inappropriate fiscal and monetary policies has been the chief problem in a macroeconomic sense. But without question the expansion of federal and federally-related debt has been a major cause of financial market congestion, upward interest rate pressures and virulent inflation expectations. This financial intrusion has undoubtedly complicated and interfered with the appropriately restrained conduct of monetary policy. All these influences have generated a deleterious impact on investment decisions, the rate of real capital formation and real economic growth.

Federal Absorption in Domestic Credit Markets
(Dollars in billions)

	1972	1973	1974	1975	1976	TQ	1977	1978	1979	1980	1981	1982	1983
Total funds raised in U.S. credit markets [1] ...	151.9	198.5	186.7	174.4	241.5	65.0	310.8	378.9	412.9	342.5	407.8	368.0[2]	458.0[2]
Raised under federal auspices	39.1	46.5	24.2	64.8	98.1	19.3	79.0	93.9	80.7	123.5	142.1	206.0	211.7
Federal borrowing from public	19.4	19.3	3.0	50.9	82.9	18.0	53.5	59.1	33.6	70.5	79.3	115.4	115.0
Borrowing for guaranteed loans	18.9	16.6	10.3	8.6	11.1	-0.1	13.5	13.4	25.2	31.6	28.0	44.0	46.6
Government-sponsored enterprise borrowing	0.7	10.6	10.9	5.3	4.1	1.4	12.0	21.4	21.9	21.4	34.8	46.6[3]	50.1[3]
Federal participation rate (percent)	25.7	23.4	13.0	37.2	40.6	29.7	25.4	24.8	19.5	36.1	34.8	56.0	46.2

---

[1] Nonfinancial sectors, excluding equities. Source: Federal Reserve Board Flow of Funds Accounts.

[2] OMB staff estimate.

[3] The FHLMC Recapitalization bill would increase borrowing to a small degree in 1983 (about 1% of total absorption). However, the government-sponsored enterprise borrowing under FHLMC would have surged to a greater and deterimental extent in 1984 under OMB projections if the bill passed.

For the next several years the Federal Home Loan Mortgage Corporation proposes a 600% expansion of its outstanding debt. If permitted, this expansion of Federally-related debt would represent a major reversal of Administration credit policy. Rather than improving the housing and mortgage finance situation, the flood of new debt from this source can be expected to worsen the very area it seeks to help. Heavy borrowing requirements will exert upward interest rate pressures and will reduce the probability of a housing recovery.

In recent years we have learned that the expansion of government spending and credit creation actually worsens economic performance. In the housing area, for example, Federal assistance since fiscal year 1979 has totalled $151.8 billion in direct loans and loan guarantees and $167.7 billion in loans by government-sponsored agencies, for a combined total of $319.5 billion in housing credit assistance. Yet, housing starts during this period have declined from a 2.2 million level in mid-1978 to less than one million in recent months. The government stimulus model does not work. The quick fix is ineffectual.

An important academic study undertaken in the early 1970's predicted this outcome.* Between the 1920's and the 1960's, government policy successfully increased the mortgage credit portion of household liabilities from about 45% to over 60%. However, as a portion of total assets, housing remained essentially fixed at around 25%. The result was that the ratio of mortgage debt to housing rose from about 25% to almost 40%. Crude as these data may be, they strongly suggest that the provision of subsidized housing credit is not the same thing as the provision of housing. Homeowners are apparently quite able to use mortgage credit to purchase assets other than just housing, e.g., consumer durable goods and perhaps even marketable financial assets.

The Privatization Issue

Passage of the recapitalization bill would not advance the objective of privatization. Although FHLMC has historically maintained a positive earnings trend, and would likely be profitable as a purely private corporation, its proposed legislation nonetheless maintains its close linkage with the Federal government. Some of the specific links to the government would be as follows:

- FHLB back-stop borrowing authority ($200 million).
- Eligibility of FHLMC securities as investments of federally-supervised institutions.

---

* Allan H. Meltzer, "Credit Availability and Economic Decisions: Some Evidence from the Mortgage and Housing Markets," Journal of Finance (June 1974), 763-777.

- SEC exemption from registration and related accounting and disclosure requirements.

- Eligibility for Federal Reserve Open Market purchases and collateral.

- Eligibility to collateralize public deposits, including Treasury tax and loan accounts and most state and local deposits.

- Eligibility for use of the Federal Reserve and FHLB district banks as fiscal agents.

These special preferences, as well as many others, have the effect of continuing to link FHLMC and its operations with the Federal government. As a result, the debt securities issued by a "quasi public" FHLMC will be accorded special preference in the nation's credit markets. The agency will thus be able to raise money at lower costs than private institutions with similar missions and objectives. The credit market benefit of a "quasi-government" status will allow FHLMC unfair competitive advantages over its private sector counterparts in the conventional mortgage business.

But the Administration has concluded that there is in fact no such animal as a quasi-government agency. Either these agencies are perceived in the market as under the government's protection, or they are seen as completely private. In view of the long list of special privileges which link FHLMC to the federal sector, it is unreasonable to conclude that the agency is "private" in any significant sense.

Moreover, the fact that the agency enjoys a clear linkage with the federal government and all the special advantages that make up that linkage leaves private sector companies in a vulnerable and weakened position. With a major expansion of the government, there is no reason to assume that large private sector lending institutions will ever seek to undertake major programmatic expansion in the mortgage finance area. With clear competitive disadvantages, and a higher cost structure in a capital-intensive industry, there is no reason to expect that private firms will invest valuable resources in an area where the cards are stacked against them.

With this in mind, the Administration believes that the proposal to recapitalize FHLMC would effectively block the development of a strong private sector mortgage finance industry. Passage of the bill would allow FHLMC to crowd out its private counterparts. This is undesirable from the standpoint of economic efficiency, and it is clearly at odds with the direction of Administration policy. In the long run a sustainable recovery in housing and housing finance conditions can only be achieved through conscious policy efforts to encourage and leave the way open for a revival and redevelopment of private sector entrepreneurship in the secondary mortgage market area.

Alternative Approach

As an alternative to the recapitalization approach, the Administration would rather explore the possibility of severing all Federal linkages with the Federal Home Loan Mortgage Corporation within a specified time interval. Of course, full privatization of FHLMC must be pursued within an overall policy framework which coordinates the full privatization of other government-sponsored agencies. This effort would involve a number of statutory changes, as well as additional measures in the regulatory area. The Administration is currently studying this approach, and we look forward to working together with the Congress in this important effort.

Federal borrowing hike may dry up credit wells

From Globe-Democrat News Services

WASHINGTON — Federal borrowing will soak up more than half of all the credit available in the United States this year, Reagan administration officials acknowledged Friday.

The estimate, far higher than any previously released by the administration, clouds hopes for lower interest rates, higher home and car sales and a healthy economic recovery.

The federal participation rate in the domestic credit markets will soar from 35 percent last year to a peacetime record of 56 percent in fiscal 1982, the Office of Management and Budget reported.

That is the highest rate since World War II and a "rather frightening development," OMB spokesman Edwin L. Dale Jr. said. "We view it as a terribly serious development."

OMB DIRECTOR David A. Stockman attributed the rise partly to the huge federal deficit, now estimated at $119 billion for 1982 and almost as much next year.

When the government runs a deficit, it has to borrow money to pay its bills. Since the Treasury automatically goes to the head of the credit queue, this tends to crowd out private borrowers and push up interest rates.

Federal borrowing "has become one of the major obstacles to lower interest rates and economic recovery," assistant OMB Director Lawrence Kudlow told the House Banking Committee Thursday. "It's not going to be helpful," Stockman conceded to reporters Friday.

The borrowing estimate comes as private economists and administration officials say the Federal Reserve Board has loosened its grip on the nation's credit supply to help launch an economic recovery and save failing businesses from collapse.

OFFICIALS AT the nation's central bank deny they have changed their policy of limiting growth in the country's supply of money and credit to slow inflation.

"If the money supply keeps going up at the rate of the past seven months, we're going to have re-inflation and high interest rates," said Norman B. Ture, undersecretary of the Treasury and a leading administration critic of the Federal Reserve.

Another Treasury official, who did not want to be named, said: "They're (the Fed) flirting with a new surge of inflation, which would be a disaster."

Others argue the short-term consequences will help the country.

"There's no question about it, the Fed has been leaning in the direction of easier money during the last six months," observes Albert Cox, president of Merrill Lynch Economics Inc. "But it is not particularly inappropriate in a period of deep recession."

Many private economists believe the central bank is concerned about the rate of business bankruptcies, running at a 40-year high.

THUS, THESE economists contend, the Federal Reserve is making sure there is enough credit available in the economy to help tide firms over until later this year, when most forecasters expect times to improve.

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Alice M. Rivlin
Director

November 17, 1981

Honorable Charles H. Percy
United States Senate
Washington, D.C. 20510

Dear Senator:

During my recent testimony before the Committee on Governmental Affairs on the Congressional budget process, you requested that we estimate, if possible, the impact on interest rates of establishing a federal credit budget, as envisioned by your bill, S.265, the Federal Lending and Oversight Control Act.

If the Congress were to begin explicitly controlling the levels of new federal credit, under procedures such as those in your bill, and began reducing total government credit demand, there is every indication that the financial markets would respond positively and that interest rates would begin to decline. Unfortunately, as I told you during the hearing, we are unable to estimate the magnitude of the impact on interest rates.

Financial markets today are concerned about total federal government borrowing, not just the unified budget deficit. Under the multiyear budget plan of the first concurrent resolution, the unified budget deficit as a percentage of GNP is expected to fall, from about 2 percent of GNP in fiscal year 1981 to about 1 percent by fiscal year 1984. There is a risk, however, that total borrowing by the federal government or under federal auspices will not decline. As the table below illustrates, total federal government borrowing in fiscal year 1982 will probably exceed the projected $65 billion unified budget deficit by a considerable margin. Off-budget borrowing, primarily to fund the Federal Financing Bank's loan activities, will add about $20 billion to Treasury borrowing in 1982. Total direct borrowing by the Treasury is, therefore, expected to reach $80 to $90 billion. The federal government will also directly influence the allocation of another $80 billion in new credit through its loan guarantee programs.

FEDERAL BUDGET DEFICITS AND BORROWING FROM THE PUBLIC (In billions of dollars)

	1982 Estimate
Unified Budget Deficit	65
Off-Budget Deficit	20
Total Deficit	85
Less:	
Means of Financing Other Than Borrowing from the Public a/	1.7
Borrowing from the Public	83.3
New Loan Guarantee Commitments b/	80

a/ Changes in cash balances, checks outstanding, and seigniorage on coins. Estimates from Mid-Session Review of the Budget, July 1981.

b/ Estimates from Office of Management and Budget, July 1981.

The financial markets recognize that federal credit programs have grown more rapidly than direct spending. Loan guarantees and the off-budget lending of the Federal Financing Bank are not included in the binding totals of the budget process. Moreover, until recently, many credit programs have been completely without limits on their levels of annual activity. The credit budgets that the Congress has experimented with in the concurrent budget resolutions this year and last are useful first steps. The totals, however, are not binding; nor are other provisions of the Budget Act, such as reconciliation, directly applicable to the credit budget.

The imposition of a binding federal credit budget, as envisioned in S.265, cannot but help reduce the fears of the financial markets about uncontrolled growth of federal credit. This would reduce upward pressures on interest rates, but we do not know how much.

If I may be of further assistance in this regard, please call on me.

Sincerely,

Alice M. Rivlin
Director

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

February 1, 1982

TO : Honorable Charles H. Percy
Attention: Bill Canis

FROM : James M. Bickley
Analyst in Public Finance
Economics Division

SUBJECT : Federal loan guarantee programs with specific statutory interest rates

You requested information on Federal loan guarantee programs which had specific statutory interest rates, such as a 7-percent maximum. You wanted to know the number of programs and the names of these programs. You requested that the Catalog of Federal Loan Guarantee Programs published in September 1977 be used, since it is the only available comprehensive presentation of loan guarantee programs.

An updated catalog is at present being prepared by the House Banking Committee and will be available this month. However, this updated catalog will be published too late for your immediate need for information. Yet, it should be noted that some programs in the 1977 Catalog have been eliminated and others added. Furthermore, statutes concerning interest rates for some programs may have been amended since 1977. Nevertheless, two important generalizations about statutory interest rate provisions of loan guarantee programs can be made based on information in the 1977 Catalog.

First, few loan guarantee (or insured loan) programs had a statutory fixed interest rate or interest rate limitation. Only 17 out of 153 loan guarantee programs which were operating or scheduled for implementation in 1977 had such statutory fixed interest provisions.

Second, most loan guarantee programs had a substantial degree of flexibility in determining interest rates. Frequently, interest rates were set by negotiations between borrowers and lenders. Yet, most programs required that the administrator establish interest rate levels. In some cases, the program's administrator was required to consider Treasury borrowing costs or comparable private borrowing costs as a guideline in setting interest rate levels. In other cases, the program's administrator was required specifically to base program interest rates on market rates paid by the Treasury or private borrowing costs. Obviously, if the interest rate charged by a loan guarantee program is linked to market interest rates, then program interest rates will vary as financial market conditions change, and interest rate costs to loan guarantee recipients will vary directly with market interest rates. This flexibility of interest rates charged by different loan guarantee programs has been particularly important in recent years, since market interest rates have been unusually volatile.

The following list of loan guarantee programs is based largely on the Catalog of Federal Loan Guarantee Programs published in 1977. However, issues of both the United States Code and United States Statutes at Large were used to examine specific provisions of loan guarantee or insurance legislation.

Programs are listed alphabetically by Department. A Yes after a program indicates that there was a fixed interest rate set by statute; a No indicates that a program did not have a fixed interest rate set by statute. Programs with a statutory fixed interest rate are followed by a brief description of the interest rate provision.

CRS-3

A LIST OF LOAN GUARANTEE PROGRAMS WITH THE EXISTENCE OF STATUTORY FIXED INTEREST RATES INDICATED

DEPARTMENT OF AGRICULTURE

Association irrigation and drainage loans (insured)--Yes.

The interest rate is set by statute at 5 percent. The 5-percent interest rate is subsidized up to the cost of Government borrowing.

Business and industrial loans (guaranteed)--No.

Business and industry loans (insured)--No.

Community facilities loans (guaranteed) (program not implemented)--No.

Community facilities loans (insured)--Yes.

The interest rate is set by statute at 5 percent of the unpaid principal. The 5-percent interest rate is subsidized up to the cost of Government borrowing.

Domestic farm labor housing loan program (insured)--No.

Emergency livestock line of credit guarantees (guaranteed)--No.

Farm emergency loan program (guaranteed)--Yes.

Interest rates are not to exceed 5 percent to borrowers for loans for actual losses and expenses for disaster damage or destroyed farm property. Insured loan rates on other than actual losses are set periodically. The Department of Agriculture has found it necessary to subsidize the 5-percent interest rate to private lenders in order to get them to participate. Subsidies are replenished through appropriations.

Farm emergency loan program (insured)--Yes.

Interest rates are not to exceed 5 percent for loans for actual losses and expense for disaster damage or destroyed farm property. Insured loan rates on other than actual losses are set periodically.

Farm operating loans (guaranteed)--No.

Farm operating loans (insured)--No.

Farm ownership loans (guaranteed)--Yes.

Interest rates are not to exceed 5 percent. The 5-percent interest rate is subsidized by FmHA. Appropriations replenish the subsidy outlay.

Farm ownership loans (insured)--Yes.

Interest rates are not to exceed 5 percent. The 5-percent interest rate is subsidized up to the Government's cost of borrowing. Appropriations replenish the subsidy.

Grazing association loans (guaranteed, not implemented)--Yes.

Interest rates on the loans are set at 5 percent maximum.

Grazing association loans (insured)--Yes.

Interest rates on the loans are set at 5 percent maximum by law. The 5-percent interest rate is subsidized up to the cost of Government borrowing. Subsidies are replenished by appropriation.

Hay storage facility loan program (guaranteed) (program not implemented)--No.

Indian tribes and tribal corporation loans (insured)--No.

Individual homeowners loans, loans for housing and buildings on potentially adequate farms (guaranteed)--No.

Individual homeowners loans, loans for housing and buildings on potentially adequate farms (insured)--No.

Recreation facilities loans (guaranteed) (program not implemented)--Yes, real estate loans; No, chattel loans.

Rates paid by the borrower for either insured or guaranteed loans would be: 5 percent (statutory limit) on real estate loans (equivalent to farm ownership loans).

Recreational facilities loans (insured)--Yes, real estate loans; No, chattel loans.

Rates paid by the borrower for either insured or guaranteed loans are: 5 percent (statutory limit) on real estate loans (equivalent to farm ownership loans).

Resources conservation and development loans (insured)--No.

Resources electrification loan guarantees (guaranteed)--No.

Rural electrification loans (insured)--Yes.

Interest rates on insured loans are at the standard rate of 5 percent, with a special 2-percent rate available for electric borrowers which have experienced extenuating circumstances or extreme hardship, or which meet special criteria set forth in the law.

Rural housing disaster loans (insured)--No.

Rural housing site loans (insured)--No.

Rural rental housing loans (guaranteed) (program not implemented)--No.

Rural rental housing loans (insured)--No.

Rural telephone loan guarantees (guaranteed)--No.

Rural telephone loans (insured)--Yes.

> Interest rates on insured loans are at the standard rate of 5 percent, with a special 2-percent rate available for telephone borrowers who have experienced extenuating circumstances or extreme hardship, or which have an average of three or fewer subscribers per mile.

Soil and water conservation loan and loan insurance program for individuals (guaranteed)--Yes.

> The maximum on the insured loans is 5 percent. The Department of Agriculture has found that a subsidy is necessary in order to get private lenders to participate. Subsidy outlays are replenished by appropriations.

Soil and water conservation loan and loan insurance program for individuals (insured)--Yes.

> The maximum on the insured loans is 5 percent. A subsidy is made to bring the interest rate up to the cost of Government borrowing. Subsidies are replenished by appropriations.

Very low income housing repair loans (insured)--Yes.

> The statutory interest rate is set at 1 percent. The 1-percent interest rate is subsidized up to the Treasury's cost of borrowing. Subsidies are replenished by appropriations.

Water waste and disposal systems for rural communities (guaranteed) (program not implemented)--Yes.

> Interest rate may not exceed 5 percent.

Waste water and disposal systems for rural communities (insured)--Yes.

> Interest rate may not exceed 5 percent.

Watershed protection and flood prevention loans (guaranteed) (program not implemented)--No.

Watershed protection and flood prevention loans (insured)--No.

DEPARTMENT OF COMMERCE

Business development loan guarantees (guaranteed)--No.

Coastal energy impact program (guaranteed)--No.

Federal ship financing guarantees (guaranteed)--No.

Fishing vessel obligation and guarantee program (guaranteed)--No.

Trade adjustment assistance for communities (guaranteed)--No.

Trade adjustment assistance for firms (guaranteed)--No.

DEPARTMENT OF DEFENSE

The Defense Production Act (guaranteed)--No.

Foreign military credit sales (guaranteed)--No.

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE (former)

Academic facilities loan insurance (insured) (program not implemented)--No.

Construction and modernization of hospitals and other medical facilities (guaranteed)--No.

Construction of health professions teaching facilities (guaranteed)--No.

Construction of nurse training facilities (guaranteed) (program not operating)--No.

Health maintenance organizations (guaranteed) (program not operating)--No.

Health professions guaranteed student loan program (guaranteed) (program not yet implemented)--No.

Health resources development (guaranteed) (program not operating)--No.

Student loans (guaranteed)--Yes.

The maximum interest rate is 7 percent.

Student loans (insured)--Yes.

The maximum interest rate is 7 percent.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

New communities loan guarantees (guaranteed)--No.

Section 203(b)--Homes for certified veterans (insured)--No.

Section 203(b)--Mortgage insurance for home purchases (insured)--No.

Section 203(h)--Homes for disaster victims (insured)--No.

Section 203(i)--Homes in outlying areas (insured)--No.

Section 203(k)--Home improvement loan insurance for housing outside urban renewal areas (insured)--No.

Section 207--Mobile home parks (insured)--No.

Section 207--Mortgage insurance for rental housing (insured)--No.

Section 213--Development of sales-type cooperative projects (insured)--No.

Section 213--Investor-sponsored cooperative housing (insured)--No.

Section 213--Management-type cooperative projects (insured)--No.

Section 213--Mortgage insurance for purchase of sales-type cooperatives (insured)--No.

Section 213(j)--Cooperative housing insurance, management-type projects--supplementary loans (insured)--No.

Section 220--Homes in urban renewal areas (insured)--No.

Section 220--Mortgage insurance for rental housing in urban renewal areas (insured)--No.

Section 221(d)(2)--Homes for low- and moderate-income families (insured)--No.

Section 221(d)(3)--Mortgage insurance for rental housing for low- and moderate-income families, market interest rate (insured)--No.

Section 221(d)(4)--Mortgage insurance for rental housing for moderate-income families (insured)--No.

Section 221(h)--Rehabilitated housing for low-income families (insured)--No.

Section 221(i)--Conversion of rental housing projects to condominiums (insured)--No.

Section 221(j)--Conversion of rental housing projects to cooperatives (insured)--Yes.

Maximum interest rate is 3 percent.

Section 222--Mortgage insurance for servicemen (insured)--No.

Section 223(e)--Housing in older, declining areas (insured)--No.

Section 223(f)--Mortgage insurance for the purchase of refinancing of existing multifamily housing projects (insured)--No.

Section 231--Mortgage insurance for rental housing for the elderly (insured)--No.

Section 232--Mortgage insurance for nursing homes and intermediate care facilities (insured)--No.

Section 233--Mortgage insurance for experimental homes (insured)--No.

Section 233--Mortgage insurance for experimental projects other than housing (insured)--No.

Section 233--Mortgage insurance for experimental rental housing (insured)--No.

Section 234(c)--Mortgage insurance for purchase of units in condominiums (insured)--No.

Section 234(c)--Construction or rehabilitation of condominium projects (insured)--No.

Section 235(i)--Homes for lower-income families (insured)--No.

Section 235(j)--Acquisition and rehabilitation of homes for resale to lower-income families (insured)--No.

Section 235(j)--Purchase of rehabilitated homes by lower-income families (insured)--No.

Section 236--Rental and cooperative housing for lower-income families (insured)-No.

Section 237--Mortgage insurance for special credit risks (insured)--No.

Section 240--Mortgage insurance for purchase by homeowners of fee simple title from lessors (insured)--No.

Section 242--Mortgage insurance for hospitals (insured)--No.

Section 244--Multifamily coinsurance (insured)--No.

Section 244--Single-family coinsurance (insured)--No.

Section 245--Experimental financing graduated payment mortgages (insured)--No.

Section 809--Armed services housing for civilian employees (insured)--No.

Section 810--Armed services housing in impacted areas (insured) (inactive)--No.

Title I--Historic preservation loans (insured)--No.

Title I--Mobile home loan insurance (insured)--No.

Title I, Section 2--Property improvement loan insurance for improving all existing structures and building of new nonresidential structures (insured)--No.

Title X--Land development and new communities (insured)--No.

Title XI--Group practice facilities (insured)--No.

DEPARTMENT OF THE INTERIOR

Bureau of Indian Affairs loan guarantee program (guaranteed)--No.

Bureau of Indian Affairs loan insurance program (insured)--No.

Guarantee of certain obligations of the Guam Power Authority (guaranteed)--No.

Guarantee of Virgin Islands bonds (guaranteed)--No.

Guarantee of Virgin Islands loans (guaranteed)--No.

DEPARTMENT OF STATE

Agricultural and productive credit and self-help community development program (guaranteed)--No.

Housing guarantee program (guaranteed)--No.

DEPARTMENT OF TRANSPORTATION

Aircraft loan guaranty program (guaranteed)--No.

Emergency Rail Services Act of 1970 guarantee of trustee certificates (guaranteed)--No.

Loan guarantees issued under the Rail Passenger Service Act of 1970 (guaranteed)--No.

National Capital Transportation Act revenue bond guarantee program (guaranteed)--No.

Railroad rehabilitation and improvement financing (guaranteed) (program not yet operating)--No.

DEPARTMENT OF THE TREASURY

Emergency Loan Guarantee Board (guaranteed)--No.

ENERGY RESEARCH AND DEVELOPMENT ADMINISTRATION

Electric and hybrid vehicle research, development, demonstration, and production (guaranteed)--No.

Geothermal loan guarantee program (guaranteed)--No.

ENVIRONMENTAL PROTECTION AGENCY

Loan guarantees for construction of treatment works (guaranteed)--No.

EXPORT-IMPORT BANK

Cooperative financing facility (CFF)--participating financial institution guarantees and guarantees on certificates of loan participation (guaranteed)--No.

Financial guarantees (guaranteed)--No.

Medium-term commercial bank guarantees (guaranteed)--No.

Medium-term export credit insurance (insured)--No.

Short-term export credit insurance (insured)--No.

FEDERAL ENERGY ADMINISTRATION

Coal loan guarantee program (guaranteed)--No.

Energy conservation and renewable resource obligation guarantees program (OGP) (guaranteed)--No.

GENERAL SERVICES ADMINISTRATION

Federal building loan guarantees (guaranteed)--No.

Real property guarantees (promissory notes guaranteed by U.S. Government) (guaranteed)--No.

OVERSEAS PRIVATE INVESTMENT CORPORATION

Investment guarantees (guaranteed)--No.

SMALL BUSINESS ADMINISTRATION

Air pollution control loans (guaranteed)--No.

Base closing economic injury loans (guaranteed)--No.

Coal mine health and safety loans (guaranteed)--No.

Displaced business loans (guaranteed)--No.

Economic injury disaster loans (guaranteed)--No.

Economic opportunity loans (guaranteed)--No.

Emergency energy shortage economic injury loans (guaranteed)--No.

Handicapped assistance loans (guaranteed)--No.

Meat, poultry inspection loans, consumer protection loans (guaranteed)--No.

Occupational safety and health loans (guaranteed)--No.

Physical disaster (guaranteed)--No.

Pollution control financing (lease guaranteed)--No.

Regular business loans (guaranteed)--No.

Small business investment company program (SBIC program) (guaranteed)--No.

Surety bond guarantee (guaranteed)--No.

Strategic arms economic injury loan (guaranteed)--No.

Water pollution control loans (guaranteed)--No.

UNITED STATES RAILWAY ASSOCIATION

Acquisition and modernization loans (guaranteed) (program never implemented)--No.

Interim maintenance and improvement loans (guaranteed)--No.

Loans for railroads in reorganization (guaranteed)--No.

Loans to State, local, or regional transportation authorities (guaranteed)--No.

VETERANS' ADMINISTRATION

Veterans housing loans (guaranteed)--No.

Veterans housing loans (insured)--No.

Veterans mobile home loans (guaranteed)--No.

Veterans mobile home loans (insured)--No.

I have attached a copy of the 1977 Catalog for your use. If you require further assistance, please call me at 287-7792.

Cosponsors of S. 265, Federal Lending Program Control Act
Sponsored by Senator Charles H. Percy--Chairman, Foreign Relations Comm.

Domenici	Chairman, Senate Budget Committee
Hatfield	Chairman, Senate Appropriations Comm.
Helms	Chairman, Senate Agriculture Comm.
Proxmire	
Biden	
Simpson	Chairman, Senate Veterans Affairs Comm.
Cohen	
Wallop	
Quayle	
Symms	
Gorton	Chairman, Budget Committee credit program task force
Harry Byrd	
Jepsen	Vice Chairman, Joint Economic Committee
Lugar	
Specter	
Mattingly	
Heinz	
Kasten	
Schmitt	

STATEMENT OF HON. ED BETHUNE, A U.S. CONGRESSMAN FROM THE STATE OF ARKANSAS

Mr. Chairman and distinguished members of the Task Force, I appreciate having this opportunity to testify before you today on the need for a credit budget. I am heartened by the fact that Congress seems ready to address a problem it has been ignoring for too long.

Off of this Hill, there is a growing $600 billion monster that is doing all sorts of things to this economy, and the truth of the matter is that none of us know that much about it. Constitutionally, the major responsibility of the Congress relates to the appropriation of federal dollars. And yet, over the past few years, we've seen credit-related activities of the federal government proliferate at an astronomical rate and do so out of the view of the public, out of the view of the economic soothsayers, but, most embarrassingly, out of the view of the Congress.

We should be concerned not only about what has happened to date in the credit area but, more significantly, concerned about what is going to happen later this afternoon, tomorrow, next week, and next year. Since the passage of the Congressional Budget Act of 1974, the government's spending window has been closing, and the public's attention has been focused on outlays and the deficit. However, while that window has been somewhat constricted, the lending window has been wide open. The creative seekers of federal assistance have lost no time in lining up--for a loan is just about as good as a direct grant from the federal government.

It's ironic to realize that for the past six months, this country's preoccupation has been with budgetary matters which don't begin to reflect the reality of the total interference in the economy. There has been heated debate here on the Hill by the economists, the journalists, the corporate leaders, et. al., about the ramifications of various budget deficit numbers. Yet, all of that ignores the impact of the federal credit programs. Under these programs, hundreds of billions of dollars are being influenced in the credit markets. Probably, much more "crowding-out" is occurring as a result of off-budget activities than from the deficit that is presently preoccupying the nation's attention.

Federal lending assistance programs also have become very attractive politically. They are, for the most part, off-budget expenditures of the federal budget so the all-important deficit number is not affected, and loan guarantees are said to have no cost to the federal government because the loans will be paid back. What is left unsaid is that there is a substantial interest subsidy paid by the government, which appears in the off-budget accounts; and in the case of guarantees, the government is allocating credit resources to ventures that may be nonproductive, and that is inflationary over the long haul.

This proliferation of federal lending assistance programs could have a most interesting and unintended effect on national economic policy. The people who are not getting federal credit assistance have noticed how many people are getting help, and they are clamoring to be included in the fun.

As the increase in lending assistance programs demonstrates, their cries for help are being answered. Taking this to its logical extreme, the federal government will eventually be asked by the borrowers who are left out to allocate all available credit in the interest of fairness.

Fortunately, Mr. Chairman, I don't see that scenario unfolding because, I am happy to report, credit enforcement language has been included in the First Concurrent Budget Resolution for FY83. The language added to the Resolution provides for point of order coverage, similar to that in Sec. 311 of the Budget Act, against new credit authorizations which would exceed the ceilings imposed in the Second Resolution. Furthermore, the amendment language provided, for the first time, crosswalk allocations of credit programs to the appropriations and authorization committees.

I would note, however, that the language, as adopted, provided for an exemption of the CCC program from the crosswalk allocation. While I can understand the concerns of those who urged this exception, I see no reason to place the CCC outside the budget process.

Unfortunately, Mr. Chairman, this credit enforcement language provides for only a one-year trial of the credit budget. I respectfully urge your support in carefully monitoring the appropriations process so that we can enforce these ceilings. If this year's experiment proves successful, it can only enhance the chances for adoption of legislation permanently including the credit budget in the Budget Act.

As a coauthor, with my distinguished colleague from California, Mr. Mineta, of H.R. 2372, the Federal Lending Oversight and Control Act, I have a great temptation to wax eloquent about its many virtues. However, since Senator Percy gave a good overview of his similar legislation, S. 265, I'll now comment on the differences in the two bills and make some suggestions for further amendments.

Title I of our bill requires reports from the Administration, the Council of Economic Advisors, and the Board of Governors of the Federal Reserve System on the impact of federal lending in the economy. Furthermore, Title I requires the reports to contain information relating to the impact of federal credit on monetary policy and the impact of federal lending on private credit.

Mr. Chairman, this information, I believe, is essential if we are to carefully determine the aggregate levels for credit activity. The full impact of federal intervention in credit markets is not yet fully known, and these reporting requirements may speed up the process.

Another difference in the two versions is the amendment to the House Rules contained in Title III of H.R. 2372. The amendment requires that authorizing committees, in carrying out their oversight responsibilities, specifically consider consistency and uniformity of credit program legislation under their jurisdiction with respect to such matters as default policy, interest rates, and loan terms.

Mr. Chairman, given the ad hoc method in which these programs were established, we now have many different lending programs with many different terms. There is often no public policy rationale for these differences; it is simply a function of the time at which the program was enacted. It is clear that we need a rational review of these programs with an eye to the differing terms and conditions. Mr. Chairman, it is my hope that this, or similar, language could be retained to achieve this goal.

Mr. Chairman, I would now like to make some recommendations for additional amendments to both S. 265 and H.R. 2372.

It is my belief that any legislation creating a credit budget should take appropriate steps to correct the problems encountered by the sale of certificates of beneficial ownership (CBOs) and by the "guarantee" of loans through the Federal Financing Bank. In creating a credit budget, Congress needs to be sensitive to these methods of reducing one's outlays or loan totals through tranfers to an off-budget account. Any credit budget proposal should include amendments that would ensure that the originating agency would still be "charged" with these transactions.

Mr. Chairman, I would now like to conclude my testimony by quickly highlighting the key points in common between S. 265 and H.R. 2372 as it relates to the creation of a Congressional credit budget process.

Both bills make direct loans and loan guarantees subject to the same target and ceiling mechanisms as are spending programs. Furthermore, under the Congressional Budget Act, controls are placed on these loan programs at the point of commitment for guaranteed loans and at the point of obligation for direct loans, and are placed on the gross program level, rather than net lending.

Both the Senate and House bills extend Section 311 point-of-order coverage to bills exceeding the limitations on obligations for direct loans or commitments to guarantee loan principal above the levels set in the second budget resolution, as incorporated in the enforcement language in the First Resolution for FY83. Conceivably, the Budget Committees could require reconciliation of credit programs under the Section 310(a) amendments in both bills.

Finally, both bills mandate March 15 reporting from authorizing committees and a special report from the House and Senate Banking Committees as to the appropriate aggregate levels of federal credit assistance. To assist them in carrying out the requirements of the budgetary process, these legislative proposals give the appropriation committees allocation and crosswalk authority with respect to credit programs.

Mr. Chairman, as you can see, both bills are identical when it comes to making the necessary and needed changes in the Congressional Budget Act of 1974. I wholeheartedly support this important concept and hope that this Committee will act forcefully in reporting such legislation.

This concludes my prepared remarks. Mr. Chairman, again, let me say how pleased I am to be here, and I would be happy to answer any questions you may have.

THE WHITE HOUSE

Office of the Press Secretary

FOR IMMEDIATE RELEASE
November 5, 1981

November 5, 1981

FACT SHEET

Federal Credit/Loan Guarantee Reduction

SUMMARY

The President today announced a program to reduce new Federal loan guarantee commitments for FY 1982 by $20.3 billion, from $181.4 billion to $161.2 billion. The loan guarantee reductions are a part of the President's efforts to relieve pressure on interest rates and to open the way for sustainable and non-inflationary economic recovery. The President has requested each of the departments and agencies affected by the planned reductions to submit to the Office of Management and Budget a specific plan detailing the administrative actions that will achieve these reductions and, where necessary, proposed legislative changes that may be required.

BACKGROUND

On September 24, President Reagan announced several new policy actions to ensure a steady follow-through toward the goals of declining deficits, a reduction in the overall Federal borrowing requirement and a balanced budget by 1984. Among the items proposed was a significant reduction in new Federal loan guarantee commitments for FY 1982.

PROPOSED REDUCTIONS IN 1982 NEW COMMITMENTS FOR LOAN GUARANTEES

The President issued a statement today detailing his proposal to reduce new FY 1982 loan guarantee commitments by $20.3 billion. The package contains 14 programs administered by 9 departments and agencies. The package would reduce estimated gross commitments from $181.4 billion to $161.2 billion.

The four major elements of the package are:

	($ billions)	
	Proposed Reduction	Current Level
GNMA (HUD)	-16.0	64.0
Rural Electrification and Telephone Revolving Fund (USDA)	-1.0	5.2
Export-Import Bank	-1.2	8.2
Small Business Administration	-1.0	5.0

The ten smaller elements of the package are:

Farmers Home Administration (USDA)	-0.3	13.40
Section 108 community development (HUD)	-0.25	0.25
MARAD Federal ship financing fund (DOT)	-0.22	0.90
Section 511 rail rehabilitation (DOT)	-0.14	0.27
Aircraft purchase loan guarantees (DOT)	-0.05	0.10
Biomass energy development (Treasury)	-0.05	0.05
NOAA fishing vessel financing (Commerce)	-0.02	0.08
Health professions guaranteed student loans (HHS)	-0.02	0.10
Defense production guarantees (DOD)	-0.03	0.03
Trade adjustment assistance (Commerce)	-0.01	0.04

For the package as a whole, new primary loan guarantee commitments for 1982 would be reduced by $4.3 billion, from the Mid-Session Review estimate of $79.4 billion to $75.2 billion. Secondary guarantees (GNMA) would be reduced by $16 billion.

THE EFFECTS OF THE LOAN GUARANTEE REDUCTIONS

Federal budget policies are having a serious adverse impact on the nation's credit markets because of the virtual explosion in recent years of Federal and federally-assisted borrowing.

For example, in the fiscal year just ended, the Federal government borrowed $78.8 billion to finance its on- and off-budget deficits and stimulated an additional $48.0 billion in borrowing for loan guarantees and $27.7 billion for government-sponsored enterprises. In sum, funds raised under Federal auspices in 1981 absorbed 43% of capital raised in the non-financial sector of the U.S. credit markets.

This direct government and government-assisted borrowing has contributed to record interest rates, disorder in financial markets and inadequate economic growth. The escalation of interest rates in recent years has made it impossible for many families to buy homes and has discouraged investments by business and industry.

Average Federal and Federally-Assisted Borrowing

	Volume ($b)	Absorption Rate (%)	GNP Deflator (%)	3-mo T-bill (%)	20-yr T-bond (%)
1955-1969	9.8	16.6	2.6	3.5	4.2
1970-1979	58.1	24.9	6.6	6.3	7.5
1980	124.4	35.5	9.0	11.4	11.4
1981	154.5 (e)	43.0 (e)	9.1 (e)	14.8 (thru Sept)	13.6 (thru Sept)

Today, while most interest rates hover near record levels, the widespread anticipation of excessive growth of future Federal credit commitments has created deeply embedded expectations of continued high inflation in the 1980's. Only clear and immediate policy action to control Federal credit and borrowing will be sufficient to reverse these expectations and clear a path for sustained interest rate reduction and economic growth in the years ahead.

With this in mind, the President's credit reduction proposal is designed to:

- Dampen inflation expectations and lower interest rates.
- Provide the financial market equivalent of a $20 billion reduction in budget outlays -- since loan guarantees are typically converted into direct spending not recorded as part of the official budget.

- Curtail the effects of government credit preemption from legitmate private enterprise.
- Improve prospects for the expansion of productive investment and the recovery of economic growth.
- Facilitate the appropriately restrained conduct of monetary policy.
- Represent the first major effort to place substantial restraint on the off-budget explosion of Federal credit demand. This will be followed by additional policy actions to reduce Federal and federally-assisted credit commitments in FY 1983 and FY 1984.

THE 1982 CREDIT REDUCTIONS BY MAJOR PROGRAM

A. Government National Mortgage Association (GNMA)

The Government National Mortgage Association's guarantee of mortgage-backed securities (GNMA's) is authorized by Title VII of the Housing and Urban Development Act of 1968. The Act allows private lenders to pool mortgages guaranteed by FHA, VA, and FmHA and to issue securities backed by these pools.

GNMA commitments grew from $1.1 billion in calendar year 1970 to $58.7 billion in 1980. Loans guaranteed rose from $0.5 billion to $20.6 billion during the same period. Outstanding GNMA securities totaled $102 billion at the end of July, 1981.

The President's $16 billion reduction in GNMA is not expected to create any adverse impact on the housing industry.

- GNMA mortgage-backed securities largely finance the turnover of existing housing stock and are responsible for less than 5% of financing for new housing construction. GNMA's are composed entirely of mortgages insured by the FHA, VA, or Farmers Home Administration. In 1980, FHA, VA, and FmHA insured only 22.5% of the dollar value of all single family mortages originated. Only a portion of these mortgages were for newly constructed unsubsidized homes -- about one-third of the mortgages guaranteed by VA, one-fifth insured by FHA and none of the FmHA mortgages. About 65% of the FHA/VA mortgages on new homes were placed in GNMA pools.

- This and other Administration policies will encourage and accelerate the development of a truly private secondary market for housing finance instruments. Both the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association will be active in selling conventional mortgage-backed securities in the coming year. These programs will be strongly supported by the expansion of private mortgage insurance activity which is already larger than comparable government insured activity.

- Major Government programs to subsidize housing will continue, and over 3.7 million households will receive housing assistance through Section 8, public housing, and housing for the elderly and handicapped programs. In addition, consideration will be given to retargeting FHA commitments toward low and moderate income areas, particularly inner cities.

B. Rural Electrification and Telephone Revolving Fund

The Rural Electrification and Telephone Revolving Fund currently provides $5 billion in loan guarantees to rural power co-ops for the construction of electric power plants. The co-ops take the guarantees to the Federal Financing Bank (FFB), which then provides the co-ops with direct loans. The $1 billion reduction planned by the President will not slow or hinder the effort to provide electricity to the rural areas of the country.

- This revision is appropriate in an industry which is increasingly seeking out private alternatives. There are sources of credit becoming available in the commercial market -- particularly in the area of pollution control facility financing which would not require direct government involvement. With appropriate use of these resources, the proposed change can be effected while still maintaining adequate levels of funding for generation projects required to serve the genuine electrical demands of rural America.

- As a result of growing Federal budget constraints the Administration's economic plan seeks to limit Federal interest subsidies, which in this area have sometimes exceeded $1 billion.

C. Export-Import Bank

The bulk of Eximbank's guarantee and insurance program (40-50%) consists of exporter insurance that assists exporters in obtaining financing for their export receivables on 60 to 120 day terms. The Foreign Credit Insurance Association (FCIA), an association of some 50 major U.S. property and casualty insurance companies, performs all business and administrative services incidental to program operation and insures first-dollar commercial losses.

The balance of exporter insurance and other guarantee programs provide political/commercial risk coverage on a medium-term (1-5 years) basis for financing of capital goods exports. Financial guarantees provide medium- and longer-term risk coverage on export finance offered by commercial banks and other institutional investors. The guarantee and insurance programs are self-financing -- that is, fees charged cover administrative expenses and anticipated claims under normal market conditions.

The $1.2 billion reduction in guarantees, from an estimated FY 1982 total of $8.2 billion, will not prove harmful to U.S. exports because:

- The Administration's general economic program of greater tax incentives and lower inflation and interest rates will have a far greater impact on the ability of exporters to obtain financing at reasonable rates than Exim's guarantee and insurance programs. Again, since Exim's programs assist only 3% of U.S. exports, the more general approach is also the more equitable.
- Studies indicate that these programs generate only limited "additionality." In other words, most exporters would still export, even without the guarantees.
- Significant cuts can be achieved by targeting the political and geographical distribution of current programs.
    - Exim covers 100% of political risk in its joint program with FCIA, yet political risk coverage is the area into which unaffiliated insurance companies are moving most aggressively.
    - Over 20% of insurance activity covers exports to industrial countries where risks are low and independent capacity should develop if Exim programs were curtailed.
- The reductions will likely be covered by larger U.S. banks assuming, on an unguaranteed basis, the guaranteed loans currently offered by regional banks, with little impact on U.S. exports.

D. Small Business Administration

The Small Business Administration provides credit assistance to small businesses through its:

- Direct and guaranteed loan programs;
- 90% guarantee of losses sustained by surety companies on bid, payment, and performance bonds (of $1 million or less) that are issued to small contractors; and
- 100% indirect guarantee of State pollution control bonds. Under this program, States issue tax-exempt pollution control equipment bonds and the SBA guarantees repayment of loans made to small businesses from the bond proceeds.

The nearly $1 billion loan guarantee reduction planned by the President, a 20% reduction below the FY 1982 estimate of slightly less than $5 billion, will, as part of the economic program of lower tax rates, regulatory relief, and anti-inflationary monetary policy, afford more assistance to a wider variety of small businesses than the SBA programs, which focus on only a few. For instance:

- Less than 0.4% of small businesses would receive SBA guarantee assistance at the $5 billion level currently estimated for 1982.
- Federal intervention in the credit markets result in an elaborate shell game, where marginal firms may squeeze out more competitive firms because of political considerations rather than market forces.
- The reduction in guarantee assistance will not have a significant adverse effect on SBA's ability to serve as a lender of last resort. It will merely eliminate assistance to those firms at the margin, i.e., those that could obtain credit without Federal assistance and those that would probably never become competitive even with Federal assistance.

THE 1982 CREDIT REDUCTION BY SMALLER PROGRAMS

A. Farmers Home Administration

The Farmers Home Administration administers a number of single family home ownership and multi-family rental housing direct and guaranteed loan programs in rural communities of less than 20,000 population. About 85% of the $3.3 billion provided in the March budget is targeted to families with income of less than $11,200 per year. FmHA subsidizes these loans down to a 1% rate to the borrower. The other $500 million of lending is for moderate income single-family housing (family income between $11,200 and $15,600).

The reduction of $289 million would be applied entirely to the moderate income housing loan program.

B. Section 108 Community Development Loan Guarantees

The Section 108 loan guarantee program provides loan guarantees to selected Community Development Block Grant recipients to finance the acquisition and rehabilitation of real property.

The $250 million reduction planned by the President, the entire amount estimated for the program in FY 1982, is needed because:

- The program has become an off-budget direct loan program since all loans guaranteed are financed by the Federal Financing Bank. Hence, the program increases off-budget outlays.

- Allows communities to mortgage their future based on unappropriated block grant funds which may in effect exacerbate the fiscal condition of the community.

- The program allows recipient cities to exceed their statutorily imposed debt ceilings since these guarantees and loans do not count against the locally or state-imposed ceilings.

C. Maritime Administration Federal Ship Financing Fund

The Federal Ship Financing Fund assists in the development of the U.S. Merchant Marine by guaranteeing construction loans and mortgages for up to 25 years of U.S. flag vessels built in U.S. shipyards.

The proposed $225 million reduction would be primarily achieved by eliminating new loan guarantees and commitments for liquified natural gas carriers (LNG) and oil drilling rigs. Loan guarantees for oil drilling rigs should be eliminated because they essentially amount to a subsidy to the oil companies.

D. Section 511 Rail Rehabilitation

Section 511 of the Railroad Revitalization and Regulatory Act of 1976 authorizes $1.0 billion total funding for this loan guarantee program. $248 million has been committed through 1981. Guaranteed loans are provided to private railroads for track and equipment purchase or rehabilitation. Loans are for a maximum term of 25 years and are cycled through the FFB. Over 95 percent of the loans guaranteed through 1981 have benefited four railroads -- the Chicago and North Western ($70 million), the Milwaukee ($116 million), and the Rock Island and Katy ($23 million each).

Unless additional applications are submitted, cutting the program by 50% will not necessitate the denial of any application.

E. Aircraft Purchase Loan Guarantee Program

The Aircraft Purchase and Loan Guarantee program, first authorized in 1957 and recently reauthorized by the Airline Deregulation Act of 1978, offers loan guarantees to commuter and charter air carriers, local air services, feeder, Alaskan, Hawaiian, helicopter and intra-state carriers.

The $50 million reduction proposed by the President will not harm commuter air carriers because they have not made substantial use of the program even though they have been given priority consideration for up to $100 million annually. Only about $40 million in 1980 and $19 million in 1981 of the loans guaranteed have been to commuter air carriers. Therefore, the bulk of the guarantees have not been allocated to the transportation community it was primarily intended to assist.

F. Health Professions Guaranteed Student Loan Program

The Department of Health and Human Services guarantees loans for all types of health professionals -- at market rates.

Loan guarantees for health professions can be reduced by $20 million because there is every reason to believe that physicians and other highly-paid practitioners have more than adequate resources from their post-graduation practices to repay private borrowers. In fact, historic default rates for health professions show student borrowers are the lowest of any occupational category.

The remaining loan guarantee level -- $80 million -- is adequate to support borrowing by those entering training for lower-paid professions.

G. Defense Production Guarantees

The Department of Defense provides guarantees for loans made by public and private financing institutions to facilitate performance of defense contracts.
This program has been used only on a very limited basis, e.g., $520,000 in 1980. The $30 million reduction will not affect the performance of defense contracts.

H. Trade Adjustment Assistance

These loan guarantees are used to assist firms that have been hurt by import competition. The majority of the trade adjustment assistance (TAA) has gone to textile and shoe firms in the Northeast and Midwest.

The $10 million reduction in FY 1982 TAA guarantees is necessary because the program loses money (the current default rate is 25%) and it allocates credit to many firms that are likely to go bankrupt. The further artificial propping-up of firms that cannot compete in today's market environment makes no economic sense.

I. Federal Ship Financing - Fishing Vessels

The fishing vessels' financing program provides Federal loan guarantees to private lenders who provide long-term debt financing to commercial fish harvesters for the construction, reconstruction, reconditioning and purchasing of fishing vessels. Last year, legislation was enacted authorizing the Department of Commerce to extend loan guarantees to fisheries and shoreside processing facilities.

The fishing vessel financing program has existed for several years and has made it possible for fish harvesters to gain access to long-term financing and for private lenders to evaluate the risk and returns of the industry. As the economy recovers and the industry gains capital stability to develop new fisheries, private lenders should be willing to make fishing vessel loans at reasonable interest rates to cover the life of fishing vessels and support shoreside fishing facilities. The $25 million reduction from the previously planned 1982 level of $75 million is a step in the direction of more private financing.

J. Biomass Energy Development

The Energy Security Act of 1980 authorized a program of loans, loan guarantees, price guarantees and purchase agreements for alcohol fuels, biomass and urban waste. The administration of the program was divided between DOE and USDA but funding was provided to Treasury for allocation to these two departments.

The proposed reduction is for an unobligated balance of $50 million to guarantee additional loans. DOE has no plans to issue new solicitations for this guarantee authority.

PROPOSED REDUCTIONS IN 1982 NEW COMMITMENTS FOR LOAN GUARANTEES
(in billions of dollars)

Adjusted Gross Mid-Session total (primary and secondary guarantees) 181.4

Item	Proposed Reduction	Current Level
GNMA Mortgage backed-securities (HUD)	-16.0	64.0
Rural Electrification and Telephone Revolving Fund (USDA)	-1.0	5.2
Export-Import Bank	-1.2	8.2
Small Business Administration	-1.0	5.0
Farmers Home Administration (USDA)	-0.3	13.4
Section 108 community development (HUD)	-0.25	.25
MARAD Federal ship financing fund (DOT)	-0.22	.90
Section 511 rail rehabilitation (DOT)	-0.14	.27
Aircraft purchase loan guarantees (DOT)	-0.05	.10
Biomass energy development (Treasury)	-0.05	.05
NOAA fishing vessel financing (Commerce)	-0.02	.08
Health professions guaranteed student loans (HHS)	-0.02	.10
Defense production guarantees (DOD)	-0.03	.03
Trade adjustment assistance (Commerce)	-0.01	.04

ADDENDUM:

Total items — 14

Total proposed reductions	$20.3b	
New Levels:		
Total primary loan guarantees		$75.4b
Total secondary guarantees		$48.5b
Guaranteed loans held as direct loans (largely FFB)		$37.3b
Total New Level		$161.2b

SENATOR PROXMIRE'S INTRODUCTORY REMARKS ON S. 2162

(From the Congressional Record, Mar. 2, 1982)

By Mr. PROXMIRE:

S. 2162. A bill to amend the Federal Financing Bank Act of 1973 to require that the receipts and disbursements of the Federal Financing Bank be included in the Federal budget, and for other purposes; to the Committee on Banking, Housing, and Urban Affairs.

TRUTH IN BUDGETING ACT OF 1982

Mr. PROXMIRE. Mr. President, I am introducing legislation to put the operations of the Federal Financing Bank in the budget of the United States. The Federal Financing Bank is a relatively obscure agency of the Treasury. It operates wholly outside the budget and the regular appropriations process, yet it holds $107 billion in outstanding loans and spends $20 billion a year. In just 8 years it has become the third largest bank in the United States; it will soon be the biggest.

The Federal Financing Bank was established by the Congress in 1973 in order to provide a more efficient method of financing Federal credit programs. The legislation creating the Bank was requested by Treasury officials who were concerned about the growing number of Federal agencies marketing their own securities in Government securities markets.

There were three ways in which Federal agencies were able to tap the Government securities market. The first was to issue their own debt securities. The proceeds from this borrowing would be used to finance the agency's program.

The second method was to sell loan assets or certificates of beneficial ownership in pools of loans held by the agency. These certificates were fully guaranteed by the issuing agency and were in reality another form of borrowing.

The third method was to guarantee securities issued by private lenders or other non-Federal entities and sold in securities markets. This financing method was typically used to finance large projects where banks or other lending institutions were reluctant to use their own money.

The end result of all this creative financing was to raise the cost of financing Federal programs. Because agency issues were often unfamiliar to investors and had complicated security provisions, they traded in thinner markets and at higher rates of interest, even though the credit risk was substantially equivalent to a U.S. Treasury security. In many cases the additional financing cost was ultimately paid by the Federal Government in the form of higher interest rate subsidies. Each agency had to employ their own separate financing staff, thereby adding further to the increased cost. Also, the marketing of new agency issues was often ill-timed with borrowing by the Treasury or other Federal agencies. For all these reasons, the Treasury concluded and the Congress agreed, that a central facility was needed to finance these separate programs.

The Federal Financing Bank Act of 1973—Public Law 93-224—established the Bank under the management of the Secretary of the Treasury. The Bank was authorized to purchase securities issued, sold, or guaranteed by a Federal agency. It was thus able to provide an alternative source of financing for the three principal methods by which Federal agencies had gained access to the Government securities market. The Bank would get its funds by selling its own securities in the market or by borrowing directly from the Treasury. By the end of fiscal year 1981, the Bank held $25 billion in agency debt securities, $52 billion in agency loan assets, and $30 billion in agency guaranteed loans for a total of $107 billion. All of these holdings were financed by Treasury borrowing.

WHY WAS THE BANK PLACED OFF-BUDGET?

Section 11(c) of the Federal Financing Bank Act provides that the receipts and disbursements of the Bank shall not be included in the totals of the budget of the U.S. Government. Why was this done? No clear reason is evident in the legislative history. The legislation, including the budget exemption, was drafted by the Treasury.

There is no discussion of the exemption in the committee reports or the floor debates. In fact, there is no evidence that the Congress ever seriously reflected upon the budget exemption or considered its implications. It was largely regarded as a technical provision prepared by the Treasury experts.

To the extent there was any discussion at all on this point, it revolved around the notion that the Bank was not intended to affect the budgetary status of existing programs. As Treasury Under Secretary Paul Volcker stated in the hearings:

> The Federal Financing Bank is not a device to remove programs from the Federal budget; nor is it a device to bring programs back into the budget. The Bank would in no way affect the existing budget treatment of Federal credit programs. If a program is financed outside of the budget, the treatment would continue. If a program is now financed in the budget, that treatment would continue. The Bank is intended to improve the financing of all Federal agencies' borrowing activities, regardless of their budgetary treatment.

In a limited sense, the Bank did not change the existing budgetary treatment of Federal credit programs. If an agency was able to avoid being included in the budget by financing its program in the private securities market, it would continue to escape the budget if it financed its program through the Federal Financing Bank. The legislation establishing the Bank took for granted existing budget procedures; it did not examine the legitimacy of those procedures.

Such an approach was understandable since the concept of the Bank had already aroused the suspicion of Federal credit agencies and their allies in the Congress. Expanding the legislation to reform existing budgetary practices would almost certainly have insured its defeat. Nonetheless, those practices needed to be reformed in 1973 and the need is even greater today.

INADEQUACY OF CURRENT BUDGET CONCEPTS

Our present system for recording credit programs in the budget is derived from the President's Commission on budget Concepts whose report in 1967 led to the establishment of the unified budget in 1969. Under these concepts, loan disbursements net of repayments are counted in the budget as an outlay. However, if the loan is sold to a private investor, the receipts from the sale can be used to offset the original outlay. Agency borrowing from either the public or the Treasury is treated as debt financing and cannot be used to offset loan outlays. Loan guarantees are not reflected in the budget since Federal funds are not directly involved unless there is a default.

The uniform budget concepts established by the Commission also attempted to close a loophole developed by several agencies in the 1960's for financing loan programs outside the budget. These agencies would finance their lending activity by selling participation certificates or certificates of beneficial ownership against pools of loans held by the agency. However, the agency would continue to hold and service the loan while guaranteeing the full payment of interest and principle on the certificate. In reality, these certificates were essentially a disguised form of borrowing. However, the agencies considered them to be asset sales and used the proceeds to offset the original loan outlays.

The President's Commission classified this type of financing as borrowing thereby preventing agencies from reducing their budget outlays through the sale of certificates. Notwithstanding the establishment of these sound principles, the Farmers Home Administration was able to secure a special statutory exemption which provided that its certificates of beneficial ownership—CBO's—are to be treated as asset sales rather than borrowing—7 U.S.C. 1932(d)(b). As a result, the Farmers Home Administration can remove its loans from the budget by selling CBO's to the public.

Consider now the options for financing an additional $1 billion in loans by the Farmers Home Administration under current budgetary arrangements and without reference to the Federal Financing Bank. The first option is to make the loans with appropriated funds. Assuming there is still a budget deficit, Treasury would obtain the funds by issuing an additional $1 billion in Treasury securities to be sold in the Government securities market. The second method would be for the Farmers Home Administration to raise the billion dollars by selling guaranteed CBO's in the same Government securities market. The third method would be to have a private lender make the loans with money obtained by issuing bond-type securities guaranteed by the Farmers Home Administration and sold in the same Government securities market.

All three financing methods are essentially the same. The money is raised in the same market, possibly from the same investors, and in each case the borrowing is backed by the full faith and credit of the Federal Government. and yet under current budgetary rules, only the first financing method would be counted in the budget. The second and third methods allow the additional billion dollars in lending to occur outside the budget. This example illustrates the inadequacy of current budget concepts and the need for a thorough revision.

The legislation establishing the Bank not only perpetuated but expanded the opportunities for offbudget financing. For example, an onbudget loan can now be removed from the budget by selling it to the Federal Financing Bank. In actuality, the loan is merely shuffled from one Federal agency to another Federal agency. Normally, the outlays arising from the loan would be deducted from the books of the agency selling the loan and added to the outlay totals of the agency buying the loan. But because the Federal Financing Bank is offbudget, the outlays do not appear in the U.S. budget.

Similarly, an offbudget loan made by a private lender and guaranteed by a Federal agency can be converted into an offbudget direct loan when it is sold to the Federal Financing Bank. In some cases, the loan is made directly by the Bank without any participation by a private lender. The borrower simply issues a promissory note that is then guaranteed by a Federal agency. The Federal Financing Bank buys the note and sends a check directly to the borrower. Although the transaction has all the characteristics of a direct loan, it appears totally outside the budget.

WHY THE BANK SHOULD BE IN THE BUDGET

Whatever the original reasons for placing the Bank outside the budget, there is no longer any justification for continuing the exclusion. The House Budget Committee and the General Accounting Office have studied the issue and both have concluded that the operations of the Bank should be in the budget.[1] Similarly, the Congressional Budget Office has extensively documented the distortions arising from the Bank's budget exemption.[2]

A budget serves two main purposes: First, it provides a complete and accurate recording of the total operations of the U.S. Government; second, it provides a rational method for allocating scarce resources among competing uses. Excluding the Federal Financing Bank from the budget violates both of these purposes.

Excluding the Federal Financing Bank from the budget misleads the public about the true size and scope of the Federal Government's activities. Had the operations of the Bank been included in the budget, total Federal outlays and the Federal budget deficit would have been $21 billion greater in fiscal year 1981. Instead of a $ 58-billion deficit, the real deficit was $79 billion.

The Reagan administration is planning to reduce the off-budget outlays of the Federal Financing Bank to $16 billion in fiscal year 1982 and to only $12 billion in fiscal year 1983. However, these projections must be taken with a considerable grain of salt. Actual outlays by the Bank over the last 5 years have increased at a rate of 29 percent a year. Moreover, during this same period, actual outlays have exceeded the initial budget estimate by 25 percent. Part of the reason is that the Office of Management and Budget has traditionally underestimated the volume of disaster loans made by the Farmers Home Administration and financed through the Bank.

The administration is also assuming the Appropriations Committees will drastically curtail credit activity under other credit programs administered by the Farmers Home Administration. Since most of the cost of these programs appears off-budget, there is little pressure on the Appropriations Committees to impose the cuts recommended by the administration. As a result, the off-budget outlays arising from the activities of the Federal Financing Bank are likely to persist at the $20 billion level over the next several years.2

---

[1] GAO report of August 3, 1977, PAD 77-70; House Budget Committee Report No. 95-1055 (1978).

[2] The Federal Financing Bank and the Budgetary Treatment of Federal Credit Activities (January 1982).

At a time when we are trying to reverse the relentless expansion of the Federal Government, we do not serve our purpose well by attempting to conceal $20 billion in additional deficit spending. This $20 billion must be borrowed by the Treasury along with the $90 to $100 billion needed to finance the recorded budget deficit. There is no difference in either type of borrowing; each has the same inflationary effect on financial markets and the economy. We are simply fooling ourselves and impairing our own credibility when we perpetuate these budgetary gimmicks.

The ready availability of off-budget financing through the Federal Financing Bank has also accelerated the growth of certain Federal credit programs that make heavy use of the Bank's facilities. In particular, the Farmers Home Administration, the Rural Electrification Administration, and the Foreign Military Sales program account for 88 percent of all the loans held by the Bank. These programs have grown rapidly since the Bank was established in 1974. For example, the Congressional Budget Office study reveals that since the Bank was established, the Rural Electrification Administration increased its annual lending by an average of 29 pecent a year, whereas prior to the Bank, the program grew at a rate of only 5 percent a year. Similarly, the rate of loan growth at the Farmers Home Administration jumped from 16 percent to 26 percent a year.

There is no doubt that most of these loans met important needs. However, because they are financed off-budget, the definition of need may not be as strict as the criteria used for on-budget programs. For example, in addition to helping small farmers, the Farmers Home Administration has financed office buildings, fast food stores, condominiums and large corporations such as Perdue Farms. Subsidized disaster loans have gone to wealthy borrowers without regard to their ability to obtain credit elsewhere. In some counties, delinquency rates are as high as 70 percent. And during 1980, when many homebuilders and auto dealers were going bust because of high interest rates, the REA launched a new program for making 5 percent loans to cable TV companies.

An argument can be made that most or all of this increased loan volume would have occurred outside the budget anyway, even without the Bank. In theory, an agency could have sold its loan assets or marketed the guaranteed securities in the private securities market, thereby escaping the budget. However, private financing would have been considerably more expensive and this increased cost might have acted as a brake on loan expansion. Moreoever, in certain cases such as the foreign military sales program, the feasibility of selling guaranteed bonds issued by developing nations is probably limited.

More importantly, the availability of off-budget financing distorts the budget allocation process regardless of whether that financing is conducted through the Federal Financing Bank or through the private securities market under existing accounting procedures. In either case, the off-budget credit programs are not subject to the same critical review we give to all of the programs that are in the budget. The off-budget programs have an edge; they do not have to compete for scarce budget dollars. As a result, there is a strong possibility that we have misallocated resources. This means that the American people are not getting the maximum benefit from their tax dollars. It also means that we in the Congress are not doing the job for which we were elected.

Another reason for putting the Federal Financing Bank in the budget is to preclude the Office of Management and Budget from manipulating the figures on the official budget deficit. The present system offers many tempting possibilities for reducing the size of the official deficit simply by changing the timing of transactions with the Federal Financing Bank. For example, when the budget is being prepared for the forthcoming budget year, OMB can estimate that the net volume of loan asset sales from the Farmers Home Administration to the Federal Financing Bank will be $2 billion less in the current year and $2 billion greater in the budget year. The effect of this simple change is to increase outlays and the deficit by $2 billion in the current year and to reduce outlays and the deficit by $2 billion in the budget year. Thus, by a simple wave of a magic accounting wand, total outlays and the deficit appear to decline by $4 billion from the current year to the budget year. In actuality, all that has happened is that the accounting entries have been changed. These manipulations would not be possible if the Federal Financing Bank were in the budget.

EFFECT OF PUTTING THE BANK IN THE BUDGET

Treasury officials have generally opposed putting the Federal Financing Bank in the budget even though the budget totals for the United States are seriously distorted by the exemption. Their argument is twofold. First, it is argued that a simple repeal of the budget exemption would result in the Treasury being charged for outlays and budget authority that should properly be attributed to the agencies initiating the transaction. If the repeal of the budget exemption were coupled with an annual appropriation to the Bank, its role would tend to change from a passive financing vehicle to an active allocator of credit among government programs. If the Bank did not have enough budget authority to meet all the claims made upon it, agencies would revert to selling their securities in the market, thereby resurrecting all of the problems that gave rise to the establishment of the Bank of 1973.

Second, the Treasury argues that the problem is not so much the off-budget status of the Bank, but rather the way certain programs are treated in the budget, particularly the favorable treatment given to CBOs issued by the Farmers Home Administration and the exclusion of guaranteed loans from the budget. Over $48 billion in Farmers Home Administration CBOs were financed by the Federal Financing Bank since its creation. About half of the $20 billion in off-budget outlays attributed to the Bank would be placed on budget and charged to the Farmers Home Administration if the special statutory provision defining CBOs as asset sales were repealed—assuming the Farmers Home Administration continued to use CBOs.

Eliminating the special exemption for Farmers Home Administration CBO's would still not close the guaranteed securities loophole which accounts for approximately one-half of the Federal Financing Bank's activity. Moreover, unless this loophole were closed, most of the loans financed by the Farmers Home Administration through the CBO route could be converted into loan guarantees and still be kept off budget. Therefore, repealing the special status of Farmers Home Administration CBO's would not, by itself, solve the problem. A more comprehensive solution is needed.

PROVISIONS OF THE LEGISLATION

The legislation I have introduced is designed to meet the arguments of the Treasury while still insuring that all of the Bank's present activity is properly recorded in the budget.

First of all, the legislation repeals section 11(c) of The Federal Financing Bank Act which places the Bank outside the budget.

Second, it authorizes the Director of the Office of Management and Budget to issue regulations to require that the outlays and budget authority arising out of the Bank's operations are charged to the appropriate Federal agency notwithstanding any contrary law or regulation. This would nullify the special treatment given Farmers Home Administration CBO's. It would also allow the OMB Director to charge the guaranteeing agency with the outlays and budget authority arising from the purchase of a guaranteed obligation by the Bank.

Third, it requires that no Federal agency may issue, sell, or guarantee a security of the type ordinarily financed in securities markets unless it is first offered for sale to the Federal Financing Bank. This provision is needed to prevent agencies from tapping the securities market directly as they did prior to 1973. The Secretary of the Treasury is authorized to determine by regulation the types of securities subject to this requirement and to waive the requirement where it is not an appropriate investment for the Bank. This requirement is not intended to apply to guarantee programs such as FHA or VA mortgage loans or similar loans which are financed by local lending institutions rather than in the Government securities market.

Fourth, the legislation will not become effective until fiscal year 1984. This will permit ample time for the Congress and the administration to adjust to the new ground rules. It will also avoid possible confusing changes in the budget for fiscal year 1983 which has already been submitted to the Congress.

The end result of my proposed legislation is to include in the budget all of the programs that are now financed off-budget through the Federal Financing Bank. The budget entries would appear in the accounts of the program agencies extending the loans or guarantees. These programs would be funded through the normal appropriations process where they would have to compete, dollar for dollar, with all other programs. The Congress and the people would get a true and accurate picture of the total size of the budget and the budget deficit. And the Congress would be in a better position to allocate budget dollars among competing programs in order to achieve the highest possible return.

RELATIONSHIP TO THE CREDIT BUDGET

Mr. President, I believe this legislation will supplement the credit budget legislation introduced in the Senate by Senator PERCY and in the House by Congressman MINETA. I strongly support this long overdue legislation and I hope that it can be enacted this year.

The credit budget legislation strengthens the credit budget system already developed by the Congress and the Carter and Reagan administrations for fiscal year 1981 and 1982. Under this system, the Appropriations Committees have established annual limitations on approximately 60 percent of the gross amount of new Federal credit activity while aggregate targets for all Federal credit activity are contained in the budget resolution.

The credit budget legislation requires Congress to establish a binding ceiling on the gross amount of Federal credit activity in the second concurrent budget resolution. The ceiling would include loan guarantees as well as direct loans. Under the present system, targets are established but they are not binding.

The legislation also makes available all of the enforcement procedures of the Congressional Budget Act in order to enforce compliance with the aggregate ceilings on credit activity. For example, it would not be in order to consider legislation providing new lending or guarantee authority if it would cause the aggregate ceiling to be exceeded.

The credit budget legislation also provides that legislation establishing new credit programs would not be in order unless it provided that the amount of credit assistance extended must be approved in advance in an Appropriations Act.

While the credit budget legislation is needed, it does not solve all the problems regarding the proper budgetary treatment of Federal credit programs. Nor will it substantially curb the growth of credit programs beyond what would have been accomplished under the current system, at least for the first few years. While in theory, the Congress could curtail program growth by setting lower binding ceilings in the budget resolution, there are several practical reasons why this is unlikely to occur.

First, most of the focus of the Congress and the public has been on the regular budget deficit. It will be difficult to concentrate the same degree of attention on the size of the credit budget, at least until its size is perceived to be politically important. Since no revenues are included in the credit budget there are no surpluses or deficits by which to measure fiscal responsibility;

Second, Congress might find it hard to reduce aggregate ceilings because there is no body of theory for predicting the economic effect of an aggregate level of Federal credit activity. Indeed, any aggregate total is a composite of many separate programs with widely different economic effects. A program of 100 percent loan guarantees financed through the securities market probably has a much greater displacement effect than a 90-percent guarantee program financed through local lending institutions, yet both are given the same weight in an aggregate credit ceiling. A change in the mix of programs could have a much greater effect on financial markets and the economy than a change in the aggregate total.

Third, the very establisment of a separate credit budget outside the framework of the regular budget might reinforce the belief by some that credit activity is less costly than spending and does not require the same degree of restraint.

For all these reasons, there would be a tendency for the Congress to set aggregate credit ceiling high enough to accommodate most of the anticipated program growth, at least until it become more familiar with the concept.

In the meantime, Congress should not permit the formal establishment of a separate credit budget to divert its attention from closing loopholes in the regular budget. Credit programs need to be counted in both when they are financed with Federal dollars. Putting the Federal Financing Bank in the budget would plug the biggest loophole in the regular budget—a $20 billion loophole. I hope the legislation to accomplish this can be adopted this year along with the credit budget legislation.

Mr. President, I ask unanimous consent that the bill and a section-by-section analysis be included in the RECORD at the end of my remarks.

There being no objection, the material was ordered to be printed in the RECORD, as follows:

S. 2162

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Truth in Budgeting Act of 1982".

REPEAL OF BUDGET EXEMPTION

SEC. 2. Section 11(c) of the Federal Financing Bank Act of 1973 (Public Law 93-224) is repealed.

ASSIGNMENT OF BUDGET IMPACT

SEC. 3. The Federal Financing Bank Act of 1973 (Public Law 93-224) is amended by adding the following new section after Section 11:

"ASSIGNMENT OF BUDGET IMPACT

"SEC. 11A. The Director of the Office of Management and Budget is authorized to issue regulations providing that the budget authority and outlays arising from the Bank's operations shall be charged to the account of the appropriate Federal agency, and such regulations shall have precedence over any other provision of law or regulation to the contrary.".

SEC. 4. Section 7 of the Federal Financing Bank Act of 1973 (Public Law 93-224) is amended by adding at the end thereof the following:

"(d) A Federal agency may not—

"(1) issue or sell an obligation of a type which is ordinarily financed in investment securities markets unless that obligation is first offered for sale to the Bank; or

"(2) guarantee an obligation of a type which is ordinarily financed in investment securities markets unless the terms of the guarantee provide that it will cease to be effective if the obligation is held by any person or governmental entity other than the agency making the guarantee or the Bank.

The Secretary of the Treasury shall issue regulations to carry out the provisions of this subsection, and such regulations shall list the types of obligations to which this subsection applies. the Secretary may waive the requirements of this subsection with respect to types of obligations that the Secretary determines are not appropriate investments for the Bank.".

EFFECTIVE DATE

SEC. 5. (a) The amendments made by this Act shall take effect on October 1, 1983.

(b) The amendments made by this Act shall not be deemed to be superseded, modified, or repealed except by a provision of law which is enacted after the date of enactment of this Act, and which amends the Federal Financing Bank Act of 1973.

SECTION-BY-SECTION ANALYSIS—TRUTH IN BUDGETING ACT

Section 1. Short title. This section states that the legislation may be cited as the "Truth in Budgeting Act of 1982".

Section 2. Repeal of Budget Exemption. This section repeals Section 11(c) of the Federal Financing Bank Act. Section 11(c) now provides that none of the receipts and disbursements of the Bank shall be included in the totals of the budget of the United States government. Section 11(c) also provides that nothing in the Federal Financing Bank Act shall affect the budget status of the Federal agencies selling obligations to the Bank or the method of budget accounting for their transactions.

Section 3. Assignment of Budget Impact. This section requires the Director of the Office of Management and Budget to issue regulations assigning the budget authority and outlays arising from the Bank's operations to the appropriate Federal agency. These regulations would have precedence over any contrary law or regulation. This authority would enable the Director of OMB to classify the sale of all certificates of beneficial ownership to the Bank as borrowing. It would also permit OMB to charge the guaranteeing agency with the budget authority and outlays arising from the purchase of any guaranteed obligation by the Bank.

Section 4. Control of Marketable Obligations. This section prohibits Federal agencies from issuing or selling obligations of a type ordinarily financed in investment securities markets unless the obligation is first offered for sale to the Bank. This provision simply clarifies authority already possessed by the Secretary of the Treasury under Section 7(a) of the Federal Financing Bank Act to specify the source of financing of any obligation issued or sold by a Federal agency. The section also prohibits Federal agencies from guaranteeing any obligation of a type ordinarily traded in investment securities markets unless the guarantee stipulates is is valid only if the obligation is held by the guaranteeing agency or the bank.

The Secretary of the Treasury is required to list by regulations the types of obligations subject to the requirements of this section. The Secretary may waive the requirements for any obligations that the Secretary determines are not appropriate investments for the Bank. All of the Secretary's determinations under this section are intended to be at his sole judgment and are final and conclusive.

This section is not intended to apply to guarantees of loans made by local lending institutions and not financed in investment securities markets such as FHA or VA mortgage loans.

Section 5. Effective Date. This section provides that the legislation will become effective on October 1, 1983.

○